MACQUARIE

The ins and outs of insuring through super

Macquarie Technical Advice Services

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About the ins and outs of insuring through super

Helping you help your clients

Helping your client decide whether to hold their insurance cover inside or outside of super requires consideration of a number of different factors. Insuring inside superannuation can often be attractive in terms of lower net costs, cash flow advantages and estate planning options when compared with insuring outside super. However, there are some traps to be mindful of, as structuring insurance outside super may make more sense for clients in certain circumstances. This guide is designed to provide you with some tools to assist you in making that assessment.

The information contained in this guide is intended for use by financial services professionals only. Clients wanting to know more about insurance and superannuation should seek advice from their financial services professional.

Overview

In or out of super – the issues

Deciding whether client insurance arrangements should be held inside or outside of super involves assessing the tax, superannuation law compliance, benefit access and the potential social security implications of each alternative.

While there are other important considerations in determining the most appropriate insurance arrangements for clients, such as cash flow and death benefit payment options for beneficiaries, the analysis in this guide focuses on tax and benefit access issues. In particular, it takes into account the numerous tax and superannuation law developments in recent years which have impacted on the scope to hold insurance inside super and the tax appeal of super arrangements.

We aim to identify some 'rules of thumb' or principles regarding the circumstances in which super or non-super arrangements may best suit your client's needs.

This guide looks at the following common types of traditional insurance cover:

- Life insurance
- Total and Permanent Disablement (TPD) insurance
- Disability Income insurance
- Trauma insurance.

Restrictions on insurance in super

Superannuation regulations restrict the types of insurance that can be put in place within a superannuation fund. The regulations require alignment of the definitions of insurance held inside superannuation with the superannuation law payment rules for death, terminal medical condition, permanent incapacity or temporary incapacity. This means that superannuation fund trustees are not able to take out new insurance from 1 July 2014 where the cover includes:

- 'Own occupation' TPD insurance and certain features and options of other TPD insurance definitions
- Certain features and options of disability income insurance definitions
- Trauma insurance.

Transitional rules ensure that cover held for existing fund members that was in place prior to 1 July 2014 is not affected.

Superannuation law requires all super fund trustees, including self managed superannuation trustees, to consider the insurance needs of members as part of the fund's investment strategy. Superannuation funds (other than defined benefit funds) are also not allowed to maintain self insurance reserves. Any insurance benefits must be backed by insurance policies.

Background on tax comparisons

This guide includes a general comparison of the tax efficiency of three different ways of funding the insurance cover, that is by the client opting for:

- **Non-super:** paying for the insurance premiums with after-tax income and holding the policy in the client's own name
- **Super CCs:** arranging for concessional contributions (CCs) to be made to a super fund and for the fund trustee to pay the premiums and hold the policy in its name with the client as the insured member, and
- **Super NCCs:** making non-concessional contributions (NCCs) to a super fund and for the fund trustee to pay the premiums and hold the policy in its name with the client as the insured member.

It also contains a discussion on the extent to which benefits funded by the particular type of cover are readily accessible to the client under a super arrangement, and whether there are other issues to consider relating to superannuation law.

Super concessional contributions and the concessional contributions cap

CCs are generally contributions made by a client's employer or personal contributions which the client claims as a tax deduction. These contributions are 'pre-tax' for the client and are taxed at 15 per cent within the super fund.

An additional 15 per cent tax (Division 293 tax) applies to certain CCs made by or on behalf of certain high income earners.

The Division 293 tax applies to an individual's low tax contributions (i.e. typically CCs within the CC cap) that, when added to the client's income, exceed a threshold of $250,000. Income used to determine liability for Division 293 tax includes taxable income (excluding taxable amounts released under the First Home Super Saver Scheme), certain trust distributions, reportable fringe benefits, total net investment losses and the low tax contributions.

A $27,500 annual cap applies to these types of contributions for all individuals in the 2023/24 financial year. Amounts exceeding the CC cap are taxed at marginal rates (less a 15 per cent offset reflecting tax paid by the super fund).

Many wealthier clients will be contributing up to that cap whether or not their insurance is arranged via superannuation. That is, they would be reaping the benefit of any difference between the tax rate applicable to their income and the tax rate applicable to the contributions in any case. So, for these clients perhaps the relevant tax comparison should be between insuring outside super or insuring inside super via NCCs (or excess CCs within the NCC cap, which are effectively 'after-tax' contributions).

Non-concessional contributions and the non-concessional contributions cap

NCCs are usually personal or spouse contributions made from after-tax sources and which the contributor does not claim as a tax deduction. A $110,000 annual cap applies to NCCs made in the 2023/24 financial year. However, where a client's total superannuation balance[1] is $1.9 million or more as at 30 June 2023, their NCC cap in 2023/24 is nil.

Clients under age 75 (at anytime in the financial year) may bring forward future annual NCC cap entitlements, subject to their total superannuation balance as at 30 June of the prior financial year. Where a client's total superannuation balance is:

- Less than $1.68 million, they can make NCCs of up to $330,000 over three years
- $1.68 million to less than $1.79 million, they can make NCCs of up to $220,000 in two years
- $1.79 million to less than $1.9 million, the bring forward arrangements are not available and their total NCCs are limited to $110,000.

Note that the latest contributions can be accepted by a super fund in the year the individual turns 75 is 28 days after the month the individual turns 75.

For NCCs made in the second or third year of a bring forward period, the client's total superannuation balance must also be less than $1.9 million as at 30 June of the prior financial year, otherwise their remaining NCC cap for that year will be reduced to nil.

Excess NCCs can be withdrawn from superannuation, along with 85 per cent of associated earnings (i.e. the earnings amount less the tax paid by the fund). If a client chooses to withdraw their excess NCCs, no excess contributions tax will be payable and any related earnings will be taxed at the client's marginal tax rate less a 15 per cent tax offset to reflect the tax paid by the fund on the earnings. Excess NCCs not withdrawn are taxed at 47 per cent in 2023/24.

1 Total superannuation balance is the sum of an individual's accumulation interest, transfer balance account (adjusted for the current balance of account based and market linked pensions and excluding personal injury contribution debits) and rollovers in transit between funds, less personal injury contributions. Self managed superannuation fund members have an additional amount included if the fund has a limited recourse borrowing arrangement that is entered into on or after 1 July 2018 and the loan is with a related party or the member has met a full condition of release.

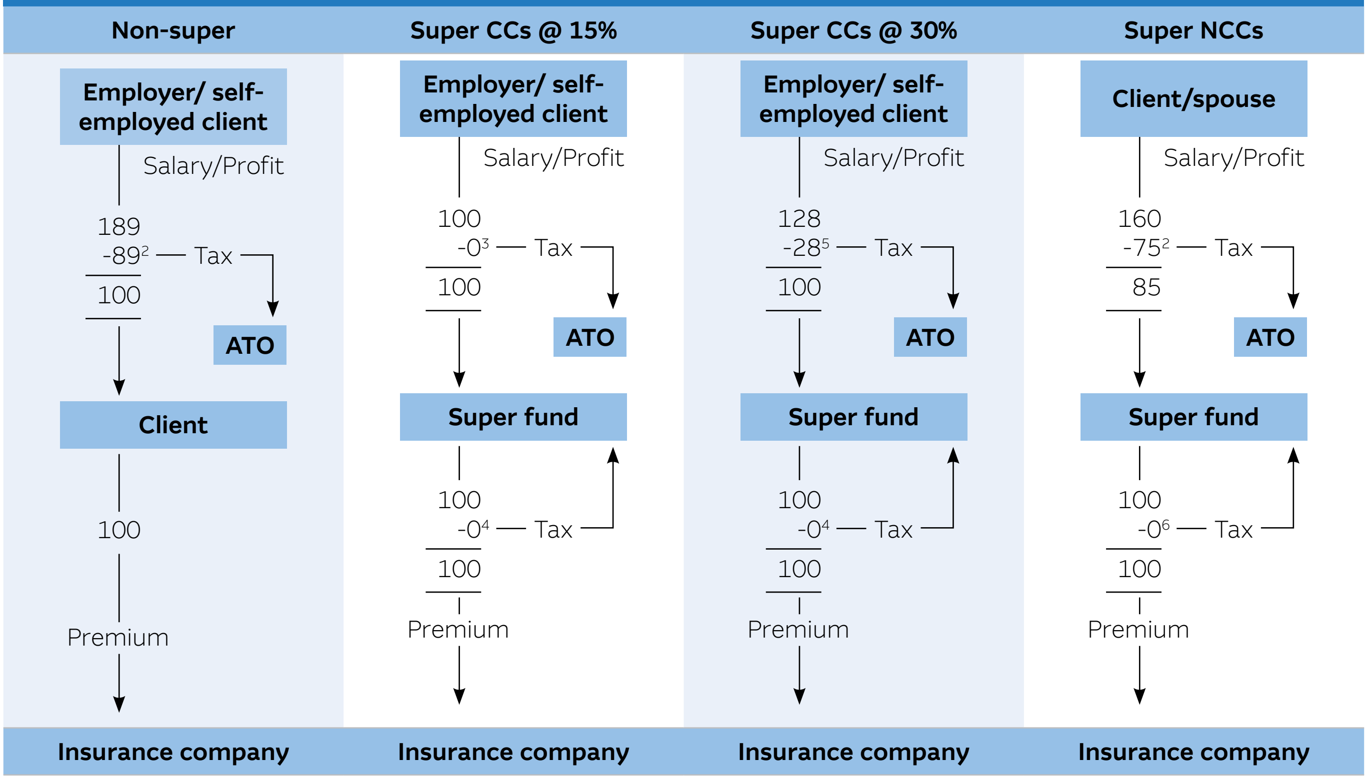
Pre-tax cost of $100 of life cover premium

This example illustrates the pre-tax cost of paying for $100 of premium for an individual on the highest marginal tax rate using the different funding options:

- non-super
- super CCs
- super NCCs.

Calculations are based on 2023/24 tax rates, including 2 per cent Medicare levy. The analysis for super CCs includes both the 15 per cent tax on contributions ('Super CCs @ 15%') and the additional 15 per cent Division 293 tax ('Super CCs @ 30%') as explained previously in **Super concessional contributions and the concessional contributions cap**.

EXAMPLE: PRE-TAX COST OF $100 LIFE COVER PREMIUM – NO BENEFITS TAX



2 Income taxed at 47 per cent, including 2 per cent Medicare levy.
3 Nil tax payable by individual either because of exclusion from assessable income (salary sacrifice contribution) or because deduction for CC offsets tax liability on income (personal deductible contribution).
4 Deduction for premium claimed by super fund offsets super fund's tax liability on CC. Assumes premium is fully tax deductible.
5 After deducting 47 per cent income tax, $15 is left to cover the Division 293 tax on the CC payable by individuals on income of $250,000 or more. Note that individuals have a choice to pay from either non-super sources or super sources. These calculations assume the tax is paid from non-super sources. If the tax is funded from within super using CCs (within the CC cap) the pre-tax cost reduces to $121.
6 Value of tax deduction for $100 premium payment, assuming the premium is fully tax deductible.

Assumptions used in this guide

Some general assumptions have been made in relation to the calculations, examples and comments made throughout this guide, as follows:

- all references to a super arrangement assume that the fund is a complying super fund and is a taxed super fund, not an untaxed fund such as certain public sector schemes
- all super contributions are within the relevant annual cap for tax purposes
- premiums in super are claimed as a tax deduction to the extent allowed under the ***Income Tax Assessment Act 1997***. Note that trustees can elect not to deduct premiums in which case a deduction at the point of a benefit payment may be allowed. Typically this is relevant only for self managed superannuation funds. For more information, see Benefit deductions instead of premium deductions on page 39
- the benefit of all super fund deductions for premium payments is credited to the client's super account. This will be common if the client has an accumulation account within the fund or if the contributions funding the premiums are CCs. It will not be common where NCCs are made to a super fund as a stand-alone insurance-only super arrangement
- no tax liability arises for a super fund trustee on insurance proceeds it receives under the policy
- no Government co-contributions or low income superannuation tax offsets have been accounted for
- where insurance is taken out inside super, the client intends to apply the relevant contributions to fund the cost of the cover rather than towards accumulating retirement benefits. If the contributions would otherwise be applied towards retirement benefits then the funding of insurance through super will result in concessionally taxed retirement savings being eroded
- in the examples where insurance is being funded inside super using NCCs, for simplicity, we have disregarded the effect of any tax free component arising from the contributions used to fund the premiums. In practice, the benefit paid out may include a small tax free component, depending on the total amount of NCCs (less withdrawals etc.) made to the account from which the benefit is paid
- the level of gross premium payable to the life company (either by the individual directly, or by the super fund) is the same for a given level of cover in each case – in practice the availability of group life arrangements and pricing differences generally may mean this is not the case
- timing issues (such as receipt of tax benefits) are ignored
- the impact of stamp duty has not been considered
- personal income tax rates used in this guide are applicable in 2023/24.

The focus of this guide is on insurance held for the purposes of providing benefits to the insured member or their beneficiaries/estate in the event of death. Some self managed super fund trustees may hold insurance for other purposes, for example, to provide liquidity or to extinguish any outstanding debt. These arrangements can be complex and involve unique considerations which are beyond the scope of this guide.

"The focus of this guide is on insurance held for the purposes of providing benefits to the insured member or their beneficiaries/estate in the event of death."

Life insurance

What is life insurance?

Life insurance provides a lump sum payment if the insured person dies or, depending on the policy terms, is diagnosed with a terminal illness.

How are benefits accessed?

Non-super benefits

Benefits payable under a life policy held outside super will generally be paid to the policy owner, or if the policy owner is the insured person, the benefit will usually be paid to their nominated beneficiaries or legal personal representative.

Super benefits

Benefits payable under a life policy held inside super will be paid to the trustee of the superannuation fund owning the policy.

There are no constraints on accessing super benefits, including any insurance proceeds, where the client is suffering from a terminal medical condition or in the event of a client's death.

In the event of death, the insurance proceeds typically form part of any superannuation death benefits paid to the client's dependants for superannuation law purposes or legal personal representative, subject to the governing rules of the superannuation fund. Whether the trustee or the insured member has control of the decision regarding to whom the benefits are paid will depend upon those governing rules.

Under superannuation law, a dependant includes the client's spouse, children, someone with whom the client has an interdependency relationship or someone who is a dependant within the ordinary meaning of that term.

A superannuation death benefit can be paid as a lump sum, pension or a combination subject to the governing rules of the fund. However, a death benefit can only be paid as a pension if, at the time of death, the recipient is either:

- a dependant for superannuation law purposes of the deceased (for example a spouse, a financial dependant or a person with whom they have an interdependency relationship) who is not a child, or
- a child of the deceased who is:
  - less than age 18, or
  - aged 18 to 24 inclusive and is financially dependent on the deceased client, or
  - aged 18 or more and has a qualifying disability.

A limit, called that transfer balance cap, applies to the amount of superannuation benefits, including insurance proceeds, that can be used to commence an income stream. Death benefit pensions are counted towards the beneficiary's transfer balance cap. In the case of death benefit pensions, the transfer balance cap ranges from $1.6 million to $1.9 million depending on the client's circumstances. Special rules apply to calculate the transfer balance cap where a death benefit pension is paid to a child of the deceased.

When deciding the form in which a death benefit should be paid, consideration should be given to the transfer balance cap available to the beneficiary. Penalties may apply where the transfer balance cap is exceeded.

In the event the client is suffering from a terminal medical condition, the client's superannuation benefits, including any insurance proceeds would generally be accessible as a superannuation lump sum under the 'terminal medical condition' condition of release.

Tax treatment of premiums and proceeds

Non-super

Where the life policy is owned by the insured person (i.e. self owned), premiums are not tax deductible and any capital gain made on the payment of a life insurance benefit is disregarded if proceeds are paid to the original policy owner or the policy was acquired for no consideration.

Within super

Premiums

Where the life policy is owned by the trustee of a superannuation fund for the purposes of paying a death or terminal medical condition benefit, premiums are generally fully tax deductible to the trustee of the fund.

It should be noted, where the life cover is taken out by the trustee of the fund for purposes other than to pay a superannuation death or terminal medical condition benefit, e.g. where the purpose of the cover is to provide for liquidity or to pay other liabilities, the premiums would generally not be tax deductible.

Proceeds

Any capital gain made on the payment of a life insurance benefit to the super fund trustee is disregarded. However, any death benefit subsequently paid from the superannuation fund may be taxable in certain circumstances.

Super benefits

Special tax treatment applies to lump sum and income stream payments made as a result of a super fund member's death or terminal medical condition.

A superannuation lump sum paid to a client because of a terminal medical condition is not taxable (it is non-assessable, non-exempt income).

The tax payable on a death benefit can depend on who receives the benefit and whether it is paid as a lump sum or income stream benefit.

Death benefit lump sum

As shown in the following table, tax payable on a lump sum death benefit will depend on the tax components of the benefit and whether the beneficiary is a dependant or non-dependant for tax purposes. A tax dependant has a slightly different meaning to dependant for superannuation law purposes. A tax dependant includes the client's spouse, minor children, someone with whom the client has an interdependency relationship or someone who is a dependant within the ordinary meaning of that term.

		Taxable component	
Beneficiary	**Tax free Component**	**Element taxed**	**Element untaxed**
Tax dependant	Non-assessable non-exempt income	Non-assessable non-exempt income	
Tax non-dependant		15%*	30%*

* Plus Medicare levy.
* For non-dependent (tax definition) beneficiaries, the element taxed and element untaxed amounts are added to the taxpayer's assessable income. The taxpayer receives a tax offset to ensure the effective tax rate does not exceed the maximum rate shown above.

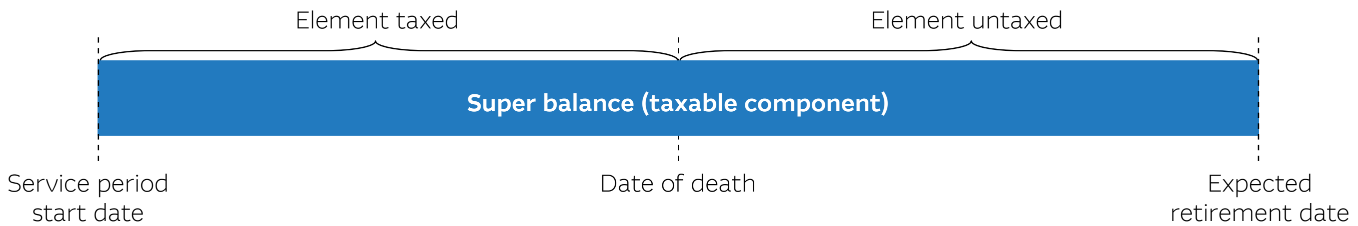
If a lump sum benefit is paid to the trustee of a deceased estate, the tax treatment will depend on whether the beneficiaries of the estate who have benefited, or are expected to benefit, from the death benefit are dependants or non-dependants. That is, the benefit will be taxed as per the above table, except that the estate is not required to pay Medicare levy.

Life insurance proceeds are generally added to the taxable component of a client's superannuation account. The taxable component may include an 'element untaxed' (see page 9).

Calculating the 'element untaxed' – lump sum benefits

Where a lump sum super death benefit (including death benefits that are rolled over to another fund) includes life insurance, the taxable component of the benefit (comprising both insurance and accumulated benefits, if any) will generally include an 'element untaxed'. An 'element untaxed' arises where the trustee has, or will, claim a deduction for the life insurance premiums or amounts based on the fund's future liability to pay a death benefit (see **Benefit deductions instead of premium deductions** on page 39). As shown in the table on the previous page, where the death benefit is paid as a lump sum to a tax non-dependant, the 'element untaxed' is taxed at a higher rate than the 'element taxed' on the basis that it represents the insured part of the benefit. If a death benefit that includes insurance is rolled over and the transferring fund has calculated an 'element untaxed' on the rollover, 15 per cent tax will be deducted from the 'element untaxed' by the receiving fund. This has the effect of converting the 'element untaxed' to 'element taxed'.

The 'element untaxed' is calculated by working out the 'future service' component of the total lump sum benefit, which is the period from death through until the expected retirement date, generally the time the client would have turned 65. The 'element taxed' represents the client's 'actual service' period, being the period from their service period start date (see over page) until their date of death. This is shown in the diagram below:



As the taxable component is split into elements taxed and untaxed in proportion to 'actual' and 'future service', a client's service period start date can impact the tax payable on super benefits paid as a lump sum to a non-dependent beneficiary or rolled over for a dependent beneficiary who is eligible to commence a death benefit pension.

Service period start date

The service period start date for the purposes of calculating tax on a superannuation lump sum benefit is typically the day the relevant client joined their super fund – that is, the period of fund membership. However, the period may start on an earlier day where:

- the benefit is (at least partly) attributable to an earlier benefit which has been rolled over into the current fund that had an earlier service period. In this case the service period of the current benefit will generally be calculated from the first day of the service period of the rolled over benefit, or
- some or all of the lump sum relates to and accrued during employment. In this case the service period will be calculated from the first day of employment with a relevant employer. Note that the employment period is typically not taken into account in calculating the service period for retail superannuation funds and SMSFs.

A client's service period is an important consideration in deciding whether insurance should be established in the same super fund as accumulating benefits or a different fund. See **Non-dependent beneficiaries – should cover be in a separate fund?** on page 15 for further information.

Death benefit income stream

Where a death benefit income stream is paid, the tax payable will depend on the age of the deceased and their dependent beneficiaries, as shown below.

		Taxable component	
Age	**Tax free Component**	**Element taxed**	**Element untaxed**
Deceased and dependant < age 60	Non-assessable non-exempt income	Marginal tax rate* less 15% tax offset	Marginal tax rate*
Deceased or dependant ≥ age 60	Non-assessable non-exempt income		Marginal tax rate* less 10% tax offset

* Plus Medicare levy.

Note that a death benefit income stream will typically only include an 'element untaxed' if it is paid from an untaxed superannuation fund.

Tax efficiency comparison

Tax comparison

This analysis considers three options for funding life insurance cover:

- **outside super –** paying for the insurance premiums with after-tax income and holding the policy in the client's own name
- **super CCs –** arranging for concessional contributions (CCs) to be made to a super fund and for the fund trustee to pay the premiums and hold the life policy in its name with the client as the insured member, and
- **super NCCs –** making non-concessional contributions (NCCs) to a super fund and for the fund trustee to pay the premiums and hold the policy in its name with the client as the insured member.

The starting point for this analysis is to consider the pre-tax cost of life insurance for each $100 of premium where the ultimate beneficiary is a tax dependant of the insured client for tax purposes.

The pre-tax cost is the amount of a client's gross remuneration package that would be needed to pay the premium. The table shows this pre-tax cost (rounded to the nearest dollar) for each $100 of premium. See *Calculating the pre-tax cost* below for relevant formulae.

<table>
<tr><th colspan="5">Pre-tax cost for each $100 of premium</th></tr>
<tr><th>Client's marginal tax rate</th><th>Non-Super</th><th>Super CC @ 15%</th><th>Super CC @ 30%</th><th>Super NCC</th></tr>
<tr><td>34.5%</td><td>$153</td><td rowspan="3">$100</td><td rowspan="2">N/A</td><td>$130</td></tr>
<tr><td>39%</td><td>$164</td><td>$139</td></tr>
<tr><td>47%</td><td>$189</td><td>$128</td><td>$160</td></tr>
</table>

Key additional assumptions

The following assumptions are made in addition to those set out in *Assumptions used in this guide* on page 6.

- **Premium deductibility**
  Under the non-super option the premiums are not deductible whereas under the super options the premiums are fully deductible to the fund trustee. In addition, it is assumed that the benefit of this tax deduction is credited to the member.

TRAP

Where insurance is held in insurance-only super arrangements and premiums are funded by contributions that are not taxable (for example NCCs) the tax effect of a deduction available to the fund trustee in relation to policy premiums is typically not credited to members' accounts.

In this situation, the pre-tax cost for each $100 of premium effectively increases where the premium is funded by Super NCCs.

- **Benefits not subject to tax**
  The benefit arising from the insurance will not be subject to income tax. That is, in the case of super, it will be paid as a lump sum to a member suffering from a terminal medical condition or someone who is a dependant of the member for tax purposes (either directly or via the deceased's estate) – see **Tax treatment of premiums and proceeds** on page 7 and **Example 3 – Life cover through super and payments to non-dependants** on page 13 for comments on benefits provided to non-dependants for tax purposes.

Calculating the pre-tax cost

The table on the right shows the life benefit formula used to calculate the pre-tax cost of each $100 of premium for life insurance, assuming the benefit is paid to a tax dependant.

Where:

- "MTR" refers to the client's marginal tax rate
- "SF tax" refers to the super fund tax rate of 15 per cent
- "Div 293 tax" refers to the additional 15 per cent Division 293 tax (assumed to be paid from non-super sources).

Funding option	Pre-tax cost
Non-super	$\frac{\$100}{(1\text{-MTR})}$
Super CCs @ 15%	$\frac{\$100 \times (1\text{-SF tax})}{(1\text{-SF tax})}$
Super CCs @ 30%	$\frac{\$100 \times (1\text{-SF tax})}{(1\text{-SF tax})} + \frac{\$100 \times \text{Div 293 tax}}{(1\text{-MTR})}$
Super NCCs	$\frac{\$100 \times (1\text{-SF tax})}{(1\text{-MTR})}$

Life insurance case studies

EXAMPLE 1 – LIFE COVER THROUGH SUPER PAID TO DEPENDANTS

Robert is 35 years old, he is on a marginal tax rate of 34.5 per cent and wants insurance cover to provide for his two children Susan and Tom (both minors) in the event of his death. Robert's adviser has determined that he needs $500,000 of life insurance. Let's assume the annual premium is $385.

? Should Robert hold his life insurance inside or outside super?

In summary, the options for Robert rank in the following order for tax efficiency:

1. inside super using concessional contributions (CCs) taxed at 15 per cent in the fund (Super CCs @ 15%) – pre-tax cost $385
2. inside super using non-concessional contributions (NCCs) – pre-tax cost $500
3. outside super – pre-tax cost $588.

Robert is better off using super and funding the premiums via CCs, followed by super with NCCs and then non-super.

As noted in **Super concessional contributions and the concessional contributions cap** on page 4, if Robert is already using his full CC cap before taking into account the funding of insurance cover but plans to increase his contributions to fund the cover, the relevant comparison is between NCCs and outside super. In any case, if Robert is not proposing to increase his super contributions to cover the cost of insurance in super then it is important to bear in mind that insuring inside super will have the effect of eroding concessionally taxed retirement savings.

1. Super CCs @ 15%

When funding insurance using CCs, any tax liability on the assessable income of the contributor is offset by a tax deduction on the CCs. The CCs are assessable income in the hands of the fund but that in turn is offset by a tax deduction on the insurance premium. As a result the pre-tax cost will always be equal to the premium. Refer to **Pre-tax cost of $100 of life cover premium** on page 5 for further guidance.

2. Super NCCs

When funding insurance using NCCs the contributor's after-tax income is used to make an NCC to super. In Robert's situation, tax of $173 is payable on his gross assessable income leaving $327 which is used to make an NCC. The NCC is not assessable income in the hands of the fund and the fund credits Robert's super account with the value of the deduction it receives for the premium payment. The pre-tax cost is $500, calculated as follows:

Income	$500
Less income tax (34.5%)	($173)
Add benefit of deduction in the super fund	$58
After-tax income/premium	**$385**

3. Outside super

Where insurance is held outside super, insurance premiums are funded with after-tax income. In Robert's situation, tax of $203 is payable on his gross assessable income leaving $385 which is used to pay the premium. The pre-tax cost is $588, calculated as follows:

Income	$588
Less income tax (34.5%)	($203)
After-tax income/premium	**$385**

EXAMPLE 2 – LIFE COVER THROUGH SUPER WHERE DIVISION 293 TAX APPLIES

Daniel is 40 years old and has one dependent child, Leah. Daniel is on a marginal tax rate of 47 per cent and is also subject to Division 293 tax (see **Super concessional contributions and the concessional contributions cap** on page 4). He requires $1,000,000 of life insurance to leave to Leah. Let's assume the annual premium is $755.

Should Daniel hold his life insurance inside or outside super?

In summary, the options for Daniel rank in the following order for tax efficiency:

1. inside super using CCs that attract Division 293 tax (Super CCs @ 30%) – pre-tax cost $969
2. inside super using NCCs – pre-tax cost $1,211
3. outside super – pre-tax cost $1,425.

As noted in **Super concessional contributions and the concessional contributions cap** on page 4, if Daniel is already using his full CC cap before taking into account the funding of insurance cover but plans to increase his contributions to fund the cover, the relevant comparison is between NCCs and outside super. If Daniel is not proposing to increase his super contributions then it is important to bear in mind that insuring inside super will have the effect of eroding concessionally taxed retirement savings.

1. Super CCs @ 30%

As with Example 1 – Life cover through super paid to dependants on page 11, when funding insurance using CCs, any tax liability on the assessable income of the contributor would be offset by a tax deduction on the CCs. Daniel will have a personal liability of 15 per cent of the amount of the CC as a result of the Division 293 tax. Assuming Daniel pays this tax from non-super sources, the pre-tax cost is $969, calculated as follows:

Income	$969
Less Division 293 tax ($113) and income tax at 47% ($101)	($214)
After-tax income/premium	**$755**

2. Super NCCs

When funding insurance using NCCs the contributor's after-tax income is used to make an NCC to super. In Daniel's situation, tax of $569 is payable on the gross assessable income leaving $642 which is used to make an NCC. The NCC is not assessable income in the hands of the fund and the fund credits Daniel's super account with the value of the deduction it receives for the premium payment. The pre-tax cost is $1,211, calculated as follows:

Income	$1,211
Less income tax (47%)	($569)
Add benefit of deduction in the super fund	$113
After-tax income/premium	**$755**

3. Outside super

Where insurance is held outside super, insurance premiums are funded with after-tax income. In Daniel's situation, tax of $670 is payable on the gross assessable income leaving $755 which is used to pay the premium. The pre-tax cost is $1,425, calculated as follows:

Income	$1,425
Less income tax (47%)	($670)
After-tax income/premium	**$755**

EXAMPLE 3 – LIFE COVER THROUGH SUPER AND PAYMENT TO NON-DEPENDANTS

Lisa is 50 years old, on a marginal tax rate of 47 per cent and has one child, Adam, who is a non-dependant for tax purposes. She has an accumulated super benefit of $300,000 (in Fund A), assumed to be all taxable component ('element taxed') and upon her death Lisa would like to leave a net benefit (including her super balance and life insurance) of $700,000 to Adam. We're assuming that Lisa is not subject to Division 293 tax (as explained in **Super concessional contributions and the concessional contributions cap** on page 4) and that any insurance cover inside super will be established in a separate insurance-only superannuation fund (Fund B). This means that benefits paid from Fund A will not include an 'element untaxed' but the benefit from Fund B will.

Should Lisa hold her life insurance inside or outside super?

In summary, the options for Lisa rank in the following order for tax efficiency:

1. inside super using CCs taxed at 15 per cent in the fund (Super CCs @ 15%) – pre-tax cost $1,067
2. outside super – pre-tax cost $1,542
3. inside super using NCCs – pre-tax cost $1,711.

As noted in **Super concessional contributions and the concessional contributions cap** on page 4, if Lisa is already using her full CC cap before taking into account the funding of insurance cover but plans to increase her contributions to fund the cover, the relevant comparison is between NCCs and outside super. If Lisa is not proposing to increase her super contributions to cover the cost of insurance in super then it is important to bear in mind that insuring inside super will have the effect of eroding concessionally taxed retirement savings.

The results show that for Lisa insuring inside super with CCs is tax efficient compared to insuring outside super or insuring inside super with NCCs.

1. Super CCs @ 15%

When insuring inside super Lisa should gross up the sum insured for tax payable when the super benefit is paid to Adam.

We're assuming that Lisa establishes cover in an insurance only superannuation fund (Fund B) and, at the time of death, she has no 'actual service' period in that fund. This means that the whole insurance benefit is 'element untaxed' and Adam will pay tax at 32 per cent on the whole amount. In addition, Adam will pay tax of 17 per cent on the benefit paid from Fund A. The grossed up level of life cover required to achieve a net benefit of $700,000 (including her accumulated super benefit) is $663,235.

Note that if Lisa established cover in the same fund as her accumulated benefits or funded the cover in Fund B with a rollover, then the amount of tax payable and therefore the level of cover required in super to achieve a net benefit of $700,000 will be different. In Lisa's case the level of cover required would be lower. These issues are covered in further detail in an extension of the Lisa example in **Life insurance and non-dependent beneficiaries** on page 15.

Let's assume that the premium for $663,235 of life cover is $1,067.

Where cover is funded with CCs, any tax liability on the assessable income of the contributor is offset by a tax deduction on the CCs. The CCs are assessable income in the hands of the fund but that in turn is offset by a tax deduction on the insurance premium. As a result, the pre-tax cost will be equal to the premium of $1,067.

2. Outside of super

There is no tax payable on an insurance benefit paid outside of super so Adam will only pay tax of $51,000 on Lisa's accumulated benefit paid from Fund A. Therefore, Lisa will need insurance of $451,000 to achieve an overall net death benefit of $700,000. Assuming the premium for $451,000 of life cover is $817, the pre-tax cost is $1,542, which is calculated as follows:

Income	$1,711
Less income tax (47%)	($725)
After-tax income/premium	**$817**

3. Super NCCs

As with Super CCs, the life cover should be grossed up for tax payable on the super benefits.

When funding insurance using NCCs the contributor's after-tax income is used to make an NCC to super. In Lisa's situation, tax of $804 is payable on the gross assessable income leaving $907 which is used to make an NCC. The NCC is not assessable income in the hands of the fund and the fund credits Lisa with the value of the deduction it receives for the premium payment. The pre-tax cost is $1,711, calculated as follows:

Income	$1,711
Less income tax (47%)	($804)
Add benefit of deduction in the super fund	$160
After-tax income/premium	**$1,067**

EXAMPLE 4 – LOOKING AFTER DEPENDANTS AND NON-DEPENDANTS

Sam is 50 years old and has three children, Rusty, Karen and Lauren. Rusty and Karen are dependants and Lauren is a non-dependant for tax purposes. Upon her death Sam would like to leave $500,000 to each child. She has the following assets:

Non-super	$500,000
Existing super (all taxable)	$500,000
Total assets	**$1,000,000**

Sam requires an additional $500,000 via life insurance in order to achieve her objective.

While insuring through super using CCs will provide the most tax efficient way of funding the insurance, different super arrangements can produce different levels of tax.

For example, the taxable component of super benefits (including benefits funded from insurance through super) is taxable if paid to a tax non-dependant whereas it is tax free if paid to a tax dependant. On that basis, when insuring inside super the sum insured typically needs to be grossed up to cover tax on super benefits that are to be paid to a tax non-dependant.

An efficient solution

Sam would not need to gross up the sum insured to cover tax on super benefits if she were to allocate her non-super assets to her non-dependent child, Lauren, and allocate her super (including insurance) to her dependent children, Rusty and Karen.

Say Sam's existing super account has been accumulated from a large NCC she has made recently so her super account comprises almost entirely of tax free component.

Assuming Sam uses a separate super fund for her life insurance, does she still need to be as concerned about the allocation of assets between dependent and non-dependent children?

The tax free component of a super benefit is not taxable when paid to either a dependant or non-dependant for tax purposes.

Another efficient solution

Sam could allocate either her non-super assets (as above) or her existing, non-insured super benefit to her non-dependent child, Lauren, who would pay little or no tax if death occurs reasonably soon after the contribution is made. During the accumulation phase, earnings generated on super contributions are classified as taxable component for benefits tax purposes. So Sam would need to be conscious that the taxable component of any death benefit ultimately paid is likely to grow over time, which may be significant if she remains alive for many years.

The separate, insurance-funded super benefit will be tax free provided it is paid to her dependent children, Rusty and Karen (but generally not if paid to Lauren).

Non-dependent beneficiaries – should cover be in a separate fund?

Where life insurance beneficiaries are not dependants for tax purposes (see **Tax treatment of premiums and proceeds** on pages 7 and 8), establishing the cover in the same fund as accumulating benefits versus a separate fund can impact on the tax efficiency of holding the cover inside super. This is because the tax payable by such beneficiaries depends on:

- the size of the accumulated benefit (and its tax components) relative to the level of insurance cover, and
- the client's service period.

It is important to note that the best fund arrangement may be different for different clients and also for different types of cover. In particular, there is a conflict between the optimal service period for death benefits and the optimal service period for permanent incapacity benefits – see **Should cover be in a separate fund?** on page 28 for further discussion on the impact of service period for TPD insurance. This means there is no general principle that can be applied to determine whether insurance should be in the same fund as accumulating benefits or a different fund. The best arrangement for a particular client will depend on their circumstances and may change over time, for example as their children get older they may no longer be financially dependent.

Life insurance and non-dependent beneficiaries

As explained in **Tax treatment of premiums and proceeds** on pages 7 and 8, to the extent that a super fund trustee has, or will, claim a deduction for life insurance premiums, the taxable component of any death benefit paid from the fund as either a lump sum or rollover may include an 'element untaxed'. This is calculated by working out the 'future service' component of the benefit, whereas the 'element taxed' of the taxable component represents the client's 'actual service'.

Taking out insurance in the same fund as a client's accumulated benefits may result in a death benefit lump sum or rollover including an 'element untaxed'. The 'element untaxed' is taxed at a higher rate than the 'element untaxed' if paid to a non-dependent beneficiary. The 'element untaxed' is also subject to 15 per cent tax if rolled over to another fund for a dependent beneficiary. On the other hand, taking out cover in a fund separate from accumulated benefits will typically mean that a death benefit paid as a lump sum or rollover from the fund not holding the insurance (i.e. consisting of accumulated benefits only) will not include an 'element untaxed' (see Calculating the 'element untaxed' – lump sum benefit paid to non-dependants on page 8). However, a potential advantage of holding cover in the same fund as accumulated benefits is that the client may have a longer 'actual service' period in that fund. The longer the client's service period in the fund holding the insurance, the greater the 'element taxed' and the lower the effective tax rate on the overall benefit.

Given these impacts, insuring in the same fund could be more or less effective than insuring in a separate fund depending on a number of factors including:

- the size and tax components of the client's accumulated benefits
- the size of their insurance benefits, and
- the client's 'actual service' and 'future service' periods.

In addition, depending on the above factors there may be some cases where insuring in the same fund as accumulated benefits is less effective than insuring outside super, even where the cover is funded with concessional contributions (CCs).

> "It is important to note that the best fund arrangement may be different for different clients and also for different types of cover."

EXAMPLE 5 – LIFE COVER IN SUPER – IMPACT OF EXISTING SUPER BALANCE AND SERVICE PERIOD

Returning to our example of Lisa, age 50 (see **Example 3 – Life cover through super and payments to non-dependants** on page 13), let's assume now that Lisa's service period in her existing super fund (Fund A) is 15 years. To recap, Lisa's balance in Fund A is $300,000 (all taxable component 'element taxed'). Upon her death Lisa would like to leave a net benefit of $700,000 (including her accumulated super benefits and life insurance) to her tax non-dependent son Adam. Lisa has a normal retirement age of 65.

Lisa has decided to hold the cover inside superannuation but she is unsure whether she should apply for her insurance via Fund A or via a separate insurance-only super account (Fund B).

Scenario 1 – Life insurance in Fund A

When insuring through super, Lisa should gross up the sum insured for tax payable when the super benefit is paid to Adam. If Lisa insures via Fund A the grossed up level of life cover required is $627,152.

This assumes Lisa passes away today with an 'actual service' period in Fund A of 15 years, which is also the same as her 'future service' period. If Lisa insures via Fund A then the taxable component of a death benefit paid from that fund would be split 50:50 between 'element taxed' and 'element untaxed' – see **Calculating the element untaxed – lump sum benefits** on page 8 for further discussion on the calculation of tax components. The net benefit payable to Adam as a result of holding insurance in Fund A is shown in the table below.

	Fund A: accumulated benefits and insurance
Actual service period	15 years
Accumulated benefit	$300,000
Life insurance	$627,152
Total death benefit payable	**$927,152**
Components Taxable component (element taxed) Taxable component (element untaxed)	 $463,576 $463,576
Tax payable	($227,152)
Net death benefit	**$700,000**

Scenario 2 – Life insurance in Fund B

As demonstrated in **Example 3 – Life cover through super and payments to non-dependants** on page 13, if instead Lisa was to arrange the life cover to be held in a second fund (Fund B), in which she has no accumulated benefit and minimal service period, then in order to provide a $700,000 net benefit to Adam (including her accumulated super benefits), Lisa's grossed up level of life cover increases to $663,235.

The reason for the increase in life cover is that additional tax is payable in Fund B, which holds the insurance. Any death benefit paid from Fund B is virtually all taxed at 32 per cent as it is primarily made up of 'element untaxed' due to a lack of past service. There is no 'element untaxed' in Fund A because no insurance is held in that fund. This is shown in the table below.

	Fund A: accumulated benefits	**Fund B: insurance only**
Actual service period	15 years	Virtually nil
Accumulated benefit	$300,000	Nil
Life insurance	Nil	$663,235
Death benefit payable	**$300,000**	**$663,235**
Components Taxable component (element taxed) Taxable component (element untaxed)	 $300,000 	 $663,235
Tax payable	($51,000)	($212,235)
Net death benefit	**$249,000**	**$451,000**
Total		**$700,000**

Scenario 3 – Life insurance in Fund B with a rollover from Fund A

If Lisa arranges insurance in Fund B (as per scenario 2 above) but funds the insurance by rolling over a benefit from Fund A, the grossed up level of life cover required to provide the same benefit to Adam reduces to $597,351. This is because the service period start date in Fund A is applied to Fund B so that any death benefit payable from Fund B is split 50:50 between elements taxed and untaxed. In addition, the benefit from Fund A consists entirely of element taxed. This is shown in the table below.

This scenario provides the best result for Lisa as the level of life cover required is lower than in scenarios 1 and 2.

	Fund A: accumulated benefits	**Fund B: insurance only**
Actual service period	15 years	15 years
Accumulated benefit	$300,000	Nil
Life insurance	Nil	$597,351
Death benefit payable	**$300,000**	**$597,351**
Components Taxable component (element taxed) Taxable component (element untaxed)	 $300,000 	 $298,675.50 $298,675.50
Tax payable	($51,000)	($146,351)
Net death benefit	**$249,000**	**$451,000**
Total		**$700,000**

TIP

Where insurance is held in a separate fund, if premiums are funded by a rollover from another fund with an earlier start date this will have the effect of applying the earlier start date to the new fund. This may benefit some clients with a lengthy service period, as the longer the 'actual service' period in the fund that holds the insurance, the lower the 'element untaxed'.

Two principles emerge from this in relation to life insurance held within superannuation, particularly where a tax non-dependant will be the recipient of the lump sum death benefits. Essentially there may be advantages in:

- holding insurance in a separate fund from accumulated benefits, and
- ensuring as long a service period as possible applies in the fund holding the insurance. However, note that for TPD insurance, a long service period can be disadvantageous (see Should cover be in a separate fund? on page 28).

Life insurance – general principles

Based on the stated assumptions (see Assumptions used in this guide on page 6 and Key additional assumptions on page 10) and analysis, we have distilled the following general principles for establishing life insurance.

Benefits to be paid to tax dependent beneficiaries

- **Funding cover in super is tax efficient if benefits are to be paid to tax dependants.** This is particularly the case where premiums are funded with concessional contributions (CCs), but still applies for non-concessional contributions (NCCs). See Tax efficiency comparison on page 10.

Benefits to be paid to tax non-dependent beneficiaries

- **Funding cover in super with CCs is tax efficient.** This is typically the case where the cover is held in a separate fund from accumulating benefits and, depending on certain factors, may also be the case if the insurance is held in the same fund. See Example 3 – Life cover through super and payment to non-dependants on page 13 and Non-dependent beneficiaries – should cover be in a separate fund? on page 15.
- **However, outside super may be more tax efficient than super NCCs.** See Example 3 – Life cover through super and payment to non-dependants on page 13 and Example 4 – Looking after dependants and non-dependants on page 14.
- **No general rule of thumb regarding holding insurance in the same fund as accumulating benefits or a separate fund.** See Non-dependent beneficiaries – should cover be in a separate fund? on page 15.

Total and permanent disablement insurance

What is total and permanent disablement insurance?

Total and permanent disablement (TPD) insurance provides a lump sum payment if the insured person becomes totally and permanently disabled in accordance with the TPD policy definition.

Two common TPD definitions offered by insurers are:

- **Own occupation**
  where the insured person is unlikely to ever again engage in their own occupation they held just prior to the total and permanent disablement
- **Any occupation**
  where the insured person is unlikely to ever again engage in gainful employment for which they are reasonably qualified through education, training or experience

However, the actual TPD definition for insurance purposes will depend on the policy terms offered by the insurance provider.

How are benefits accessed?

Non-super benefits

Benefits payable under a TPD policy held outside super will generally be paid to the policy owner.

Super benefits

Benefits payable under a TPD policy held inside superannuation will be paid to the trustee of the superannuation fund owning the policy. The proceeds will then typically form part of the member's benefit within the fund.

In order to pay any superannuation benefits from the fund, the trustee must be satisfied the member has met a superannuation law condition of release, such as permanent incapacity.

New cover taken out within superannuation from 1 July 2014 will typically be aligned with the superannuation law definition of permanent incapacity (see **Restrictions on insurance in super** on page 3). If this definition is satisfied it provides the fund trustee with grounds on which they may pay a benefit (comprising the TPD policy proceeds) to the client immediately. This will be particularly important for clients under preservation age, as they will typically be unable to satisfy other conditions of release such as commencing a transition to retirement pension (after attaining preservation age) or 'retirement'.

Where the client has met the permanent incapacity condition of release, their superannuation benefits can be paid as a lump sum, pension or a combination (subject to the governing rules of the fund). Note that the transfer balance cap ($1.9m in 2023/24) may limit the amount of superannuation benefits, including insurance proceeds, that can be used to commence a pension. Penalties may apply where the transfer balance cap is exceeded.

TRAP: 'Own occupation' TPD permanent incapacity

For some types of insurance, such as 'own occupation' TPD, there is a potential mismatch between the insurance policy definition (which determines when insurance proceeds are paid to the fund trustee) and the superannuation law definition of permanent incapacity. If this type of insurance is held inside super it is quite possible that insurance proceeds could be paid to the fund but the client would be unable to satisfy a condition of release in order to receive a benefit immediately.

However, superannuation fund trustees are not able to take out 'own occupation' TPD insurance from 1 July 2014 (see **Restrictions on insurance in super** on page 3).

For any 'own occupation' TPD cover that was in place prior to 1 July 2014, consider restructuring the cover so that the part of the cover that is aligned with the permanent incapacity definition is held inside super and the remainder is held outside super.

Tax treatment of premiums and proceeds

Non-super

Where the TPD policy is owned by the insured person (i.e. self owned), premiums are not tax deductible and any capital gain made on the payment of a TPD insurance benefit is disregarded where the benefit is paid to the insured person or their relatives.

Within super

Premiums

TPD premiums paid by super funds are only deductible to the extent that the premium covers insured events that would result in the fund being liable to pay a 'disability superannuation benefit'.

Broadly, that definition requires two medical practitioners to have certified that, because of ill-health, it is unlikely that the client can ever be gainfully employed in a capacity for which they are reasonably qualified because of education, experience or training. This means that the cover inside super needs to be more in the nature of 'any occupation' cover to qualify for a full tax deduction.

TPD insurance established from 1 July 2014 will typically be 'any occupation' cover, as superannuation regulations do not permit 'own occupation' cover to be taken out within super from that date. See **'TRAP: 'Own occupation' TPD deductibility** below for cover taken out prior to 1 July 2014.

Where the TPD cover is taken out by the trustee of the fund for purposes other than to pay a disability superannuation benefit, e.g. where the purpose of the cover is to provide for liquidity or to pay other liabilities, the premiums would generally not be tax deductible.

Proceeds

Any capital gain made by the trustee of a superannuation fund on the payment of an insurance policy related to injury or illness (e.g. TPD insurance) is disregarded.

However, any benefit subsequently paid from the superannuation fund may be taxable.

TRAP: 'Own occupation' TPD deductibility

Premiums for 'any occupation' TPD insurance are typically fully deductible to the trustee of the fund, but premiums for 'own occupation' TPD are not fully deductible.

A super fund may have a number of options available to determine the deductible part of a premium for 'own occupation' TPD insurance (or other TPD insurance that is not fully aligned with the 'disability superannuation benefit' definition).

The insurer may define the deductible portion of the premium in the policy, in which case the fund may claim this portion. Alternatively, the fund may either seek an actuary's certificate or have regard to tax regulations which prescribes deductible percentages for typical TPD insurance definitions. These regulations provide a backstop or default means of claiming a deduction for trustees who wish to avoid the costs associated with actuarial certification. In the case of 'own occupation' TPD insurance, they provide that a premium is 67 per cent deductible. See **Taxation Ruling TR 2012/6** for further information.

However this is only relevant where cover was in place prior to 1 July 2014, as superannuation fund trustees are not able to take out 'own occupation' TPD insurance from that date (see Restrictions on insurance in super on page 3).

For clients who require 'own occupation' TPD insurance advisers should consider arrangements which allow the deductible part of the cover to be held inside super and the remainder to be held outside super (see Example 10 – A solution to the need for 'own occupation' TPD on page 26).

Disability superannuation benefits

Special tax treatment applies to lump sum and pension payments made from superannuation as a result of a client's permanent incapacity. The actual tax payable can depend on the age of the client and whether the benefit is paid as a lump sum or pension.

Lump sum

A lump sum disability superannuation benefit is taxed as follows in 2023/24:

		Taxable component	
Taxpayer's age	**Tax free component**	**Element taxed**	**Element untaxed**
Under preservation age	Non-assessable non-exempt income	20%	30%* up to $1,705,000[7] 45%* above $1,705,000[7]
Preservation age to 59		0% up to $235,000[8] 15%* above $235,000[8]	15%* up to $235,000[8] 30%* from $235,000[2] – $1,705,000[7] 45%* above $1,705,000[7]
60 and over	Non-assessable non-exempt income		15%* up to $1,705,000[7] 45%* above $1,705,000[7]

* Plus Medicare levy.

TPD insurance proceeds paid to the trustee of a taxed superannuation fund are added to the taxable component (element taxed) of a client's superannuation account. However, a lump sum disability superannuation benefit may include an additional tax free component – see **Additional tax free component for lump sum disability superannuation benefits** below.

Income stream

An income stream disability superannuation benefit is taxed as follows:

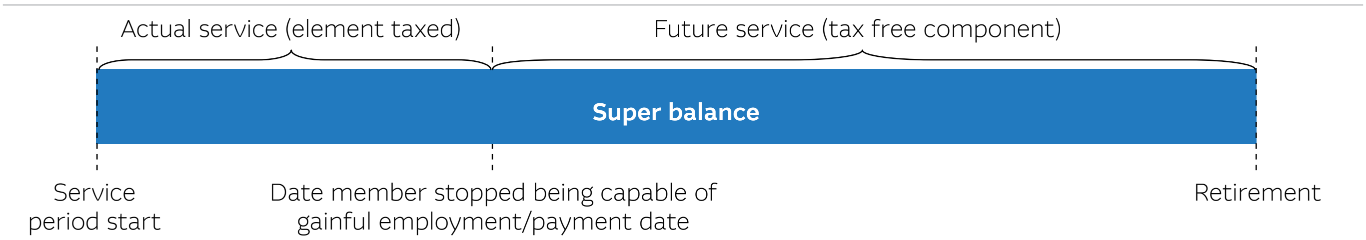
		Taxable component	
Taxpayer's age	**Tax free component**	**Element taxed**	**Element untaxed**
Under 60	Non-assessable non-exempt income	Marginal tax rate* less 15% tax offset	Marginal tax rate*
60 and over	Non-assessable non-exempt income		Marginal tax rate* less 10% tax offset

* Plus Medicare levy.

A disability superannuation benefit will typically only include an 'element untaxed' if it is paid from an untaxed superannuation fund.

Additional tax free component for lump sum disability superannuation benefits

A lump sum disability superannuation benefit may include an additional tax free component, which is worked out by calculating the 'future service' component of the benefit. The 'future service' is generally the period from the date the client stopped being capable of gainful employment through until the time they turn 65. The taxable component is the amount of the benefit less the tax free component and, in the case where there is no accumulated tax free component, represents 'actual service' which is the period from the service period start date to the date of payment. This is shown in the diagram below:



7 Untaxed plan cap in 2023/24. This is a lifetime cap which is indexed annually with Average Weekly Ordinary Time Earnings (AWOTE) rounded down to the nearest $5,000.
8 Low rate cap in 2023/34. This is a lifetime cap which is indexed annually with AWOTE, rounded down to the nearest $5,000. This cap is reduced by previous taxable lump sum member benefits received between preservation age and age 60.

Service period start date

The service period start date for the purposes of calculating tax on a superannuation lump sum benefit is typically the day the relevant client joined their super fund – that is, the period of fund membership. However, the period may start on an earlier day where:

- the benefit is (at least partly) attributable to an earlier benefit which has been rolled over into the current fund that had an earlier service period. In this case the service period of the current benefit will generally be calculated from the first day of the service period of the rolled over benefit, or some or
- all of the lump sum relates to and accrued during employment. In this case, the service period will be calculated from the first day of employment with a relevant employer. Note that the employment period is typically not taken into account in calculating the service period for retail superannuation funds and SMSFs.

Note that in practice, there will typically be some overlap in the two periods as the payment will be made some time after the date the member stopped being capable of gainful employment. However, the ATO has clarified that, in calculating the additional tax free component, no day should be counted twice in working out a member's total service period.[9]

As the 'future service' portion forms the tax free component, a key principle for TPD insurance is to have as little 'actual service' period applying to a benefit as possible, because that will typically optimise the tax free component. See **Should cover be in a separate fund?** on page 28 for further information about the impact this may have on the decisions of whether insurance should be established in the same superannuation fund as accumulating benefits or a different fund.

Tax efficiency comparison

Tax comparison

In this analysis, we consider three options for funding TPD insurance cover:

- **outside super –** paying for the insurance premiums with after-tax income and holding the policy in the client's own name
- **super CCs –** arranging for concessional contributions (CCs) to be made to a super fund and for the fund trustee to pay the premiums and hold the TPD policy in its name with the client as the insured member, and
- **super NCCs –** making non-concessional contributions (NCCs) to a super fund and for the fund trustee to pay the premiums and hold the TPD policy in its name with the client as the insured member.

As with life insurance, the starting point for this analysis is to consider the pre-tax cost of TPD insurance for each $100 of premium.

The pre-tax cost is the amount of a client's gross remuneration package that would be needed to pay the premium. The table shows this pre-tax cost (rounded to the nearest dollar) for each $100 of premium for clients age 49 and under. See Calculating the pre-tax cost on page 24 for relevant formulae.

<table>
<tr><th colspan="5">Pre-tax cost for each $100 of premium</th></tr>
<tr><th>Client's marginal tax rate</th><th>Non-Super</th><th>Super CCs @ 15%</th><th>Super CCs @ 30%</th><th>Super NCCs</th></tr>
<tr><td>Effective benefits tax</td><td>N/A</td><td>0% – 15%</td><td>0% – 15%</td><td>0% – 15%</td></tr>
<tr><td>34.5%</td><td>$153</td><td rowspan="3">$100 – $118</td><td rowspan="2">N/A</td><td>$130 – $153</td></tr>
<tr><td>39%</td><td>$164</td><td>$139 – $164</td></tr>
<tr><td>47%</td><td>$189</td><td>$128 – $146</td><td>$160 – $ 189</td></tr>
</table>

Key additional assumptions

The following assumptions are made in addition to those set out in the **Assumptions used in this guide** on page 6.

- **Premium deductibility**
  Under the non-super option the TPD premiums are not deductible whereas under the super option the premiums are deductible to the fund trustee.

TRAP

Where insurance is held in insurance-only super arrangements and premiums are funded by contributions that are not taxable (for example NCCs) the tax effect of a deduction available to the fund trustee in relation to policy premiums is typically not credited to members' accounts.

In this situation, the pre-tax cost for each $100 of premium effectively increases where the premium is funded by super NCCs and a non-super arrangement may be preferred.

9 See ATO, Calculating components of a super benefit, Disability lump sum benefits.

- **Benefits tax – super**
  For simplicity, in calculating the increased tax free portion, we assume that the client becomes disabled and receives the payment at the same time (see **Additional tax free component for lump sum disability superannuation benefits** on page 20).

Under both the Super CC and NCC options, the taxable component of benefits paid is taxed at 22 per cent when paid to a client under preservation age. However, the taxable component is reduced by the increased tax free amount associated with a disability superannuation benefit. The increased tax free amount reduces the overall effective tax rate applicable to the benefit as a whole (referred to as the 'effective benefits tax rate').

For a client age 49 or less, who has service commencing at age 15 or later, the 'effective benefits tax rate' cannot be greater than 15 per cent – see **Example 6 – 'Effective benefits tax rate' for a client aged 49 or less** below.

However, the 'effective benefits tax rate' may be slightly higher than 15 per cent for clients aged 50 or more but less than preservation age with a service period that commenced before age 31 – see **Example 7 – 'Effective benefits tax rate' for a client aged 50 or more but less than preservation age** on page 23.

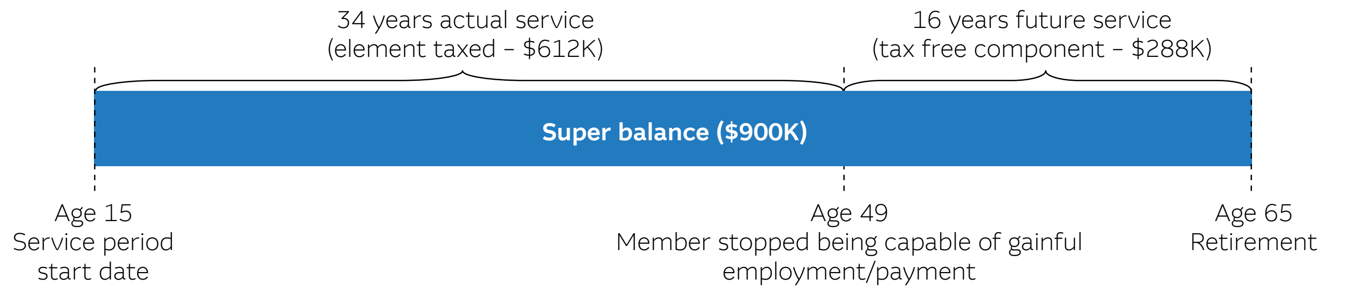
The maximum actual tax rate drops to 17 per cent for clients aged preservation age to 59 inclusive (reducing the 'effective benefits tax rate' – see **Example 8 – 'Effective benefits tax rate' for a client aged preservation age to 59** on page 23), and no tax is payable from age 60.

The pre-tax cost comparisons above are based on a maximum 'effective benefits tax rate' of 15 per cent.

EXAMPLE 6 – 'EFFECTIVE BENEFITS TAX RATE' FOR A CLIENT AGED 49 OR LESS

James, age 49, has $900,000 in superannuation (all taxable component), which includes the proceeds from a TPD insurance policy. His super fund has a service period of 34 years and he has a normal retirement age of 65.

James applies to the trustee of his super fund to withdraw his super benefits under the permanent incapacity condition of release. James has 34 years 'actual service' in his fund and 16 years 'future service' (i.e. the period of time from age 49 until age 65) and any disability superannuation benefit paid from the fund would be split between tax free component and taxable component (element taxed), as shown in the diagram below.

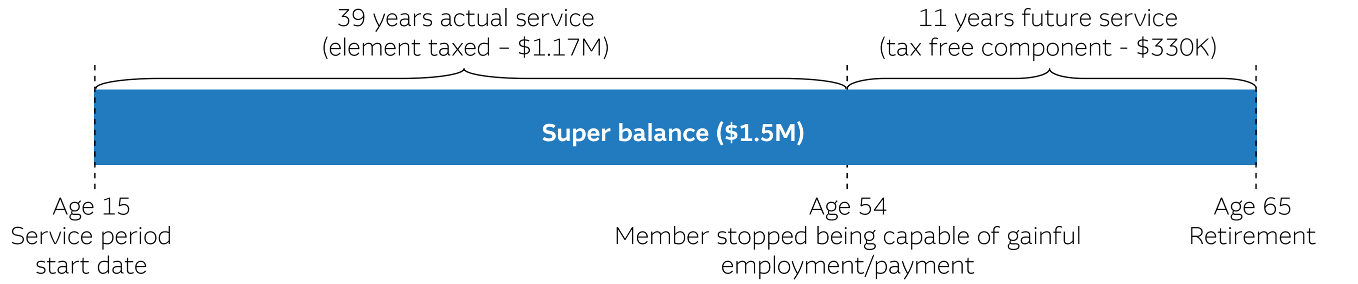


James is under preservation age and tax of 22 per cent is payable on the taxable component (element taxed). No tax is payable on the tax free component. As approximately 68 per cent of any disability superannuation benefit paid to James will be taxable, this equates to an 'effective benefits tax rate' of 14.96 per cent applying to his overall benefit. To illustrate, if James withdrew his $900,000 super benefit, tax of $134,640 would be payable on the taxable component (i.e. 22 per cent of $612,000). If this tax liability is apportioned across James' total disability super benefit, the 'effective benefits tax rate' becomes 14.96 per cent (i.e. $134,640 divided by $900,000).

EXAMPLE 7 – 'EFFECTIVE BENEFITS TAX RATE' FOR A CLIENT AGED 50 OR MORE BUT LESS THAN PRESERVATION AGE

Jeff, age 54, has $1,500,000 in superannuation (all taxable component), which includes the proceeds from a TPD insurance policy. His super fund has a service period of 39 years and he has a normal retirement age of 65.

Jeff applies to the trustee of his super fund to withdraw his super benefits under the permanent incapacity condition of release. Jeff has 39 years actual service in his fund and 11 years future service (i.e. the period of time from age 54 until age 65) and any disability superannuation benefit paid from the fund would be split between tax free component and taxable component (element taxed), as shown in the diagram below.



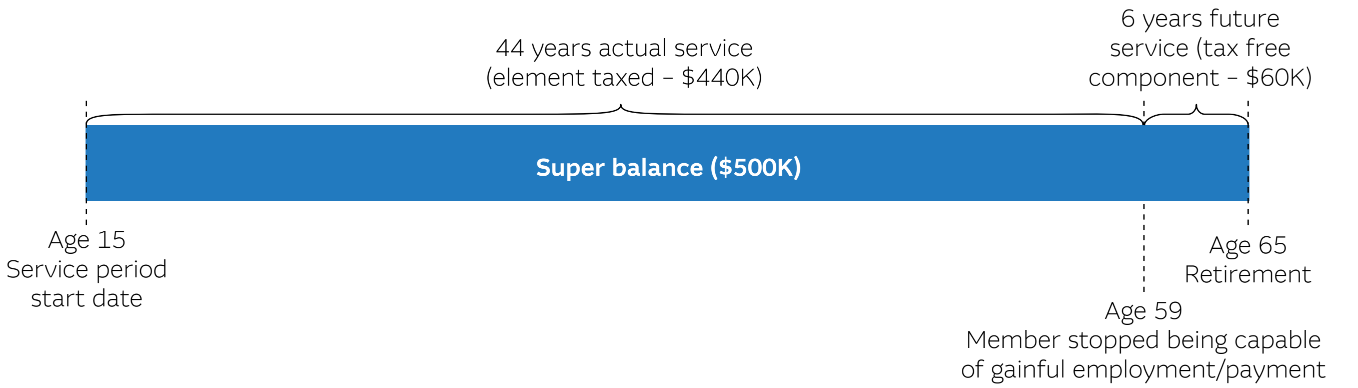
Jeff is under preservation age and tax of 22 per cent is payable on the taxable component (element taxed). No tax is payable on the tax free component. As approximately 78 per cent of any disability superannuation benefit paid to Jeff will be taxable, this equates to an 'effective benefits tax rate' of 17.16 per cent applying to his overall benefit.

To illustrate, if Jeff withdrew his $1,500,000 super benefit, tax of $257,400 would be payable on the taxable component (i.e. 22 per cent of $1,170,000). If this tax liability is apportioned across Jeff's total disability super benefit, the 'effective benefits tax rate' becomes 17.16 per cent (i.e. $257,400 divided by $1,500,000).

EXAMPLE 8 – 'EFFECTIVE BENEFITS TAX RATE' FOR A CLIENT AGED PRESERVATION AGE TO 59

Jenny, age 59, has $500,000 in superannuation (all taxable component), which includes the proceeds from a TPD insurance policy. Her super fund has a service period of 44 years and she has a normal retirement age of 65.

Jenny applies to the trustee of her super fund to withdraw her super benefits under the permanent incapacity condition of release. Jenny has 44 years actual service in her fund and 6 years future service (i.e. the period of time from age 59 until age 65) and any disability superannuation benefit paid from the fund would be split between tax free component and taxable component (element taxed), as shown in the diagram below.



As Jenny has reached her preservation age (but is under age 60), amounts withdrawn from the taxable component (element taxed) up to the low rate cap ($235,000 in 2023/24) are tax free and the excess above the low rate cap tax are taxed at 17 per cent. No tax is payable on the tax free component.

Assuming Jenny has no low rate cap remaining, if she withdrew her $500,000 super benefit, tax of $74,800 would be payable on the taxable component (i.e. 17 per cent of $440,000). If this tax liability is apportioned across Jenny's total disability super benefit, the 'effective benefits tax rate' becomes 14.96 per cent (i.e. $74,800 divided by $500,000). The 'effective benefits tax rate' would be further reduced if Jenny had not previously utilised the low rate cap, as a portion of the taxable component would also be taxed at 0 per cent.

Calculating the pre-tax cost

The table below shows the TPD benefit formula used to calculate the pre-tax cost of each $100 of premium for TPD insurance.

Where:

- “MTR” refers to the client’s marginal tax rate
- “SF tax” refers to the super fund tax rate of 15 per cent
- “BF tax” is the effective benefits tax that is payable on superannuation lump sums
- “Div 293 tax” refers to the additional 15 per cent Division 293 tax (assumed to be paid from non-super sources).

Funding option	Pre-tax cost
Non-super	$\frac{\$100}{(1\text{-MTR})}$
Super CCs @ 15%	$\frac{\$100 \times (1\text{-SF tax})}{(1\text{-SF tax}) \times (1\text{-BF tax})}$
Super CCs @ 30%	$\frac{\$100 \times (1\text{-SF tax})}{(1\text{-SF tax}) \times 1\text{-BF tax})} + \frac{\$100 \times \text{Div 293 tax}}{(1\text{-MTR})}$
Super NCCs	$\frac{\$100 \times (1\text{-SF tax})}{(1\text{-MTR}) \times (1\text{-BF Tax})}$

Note – calculations for the pre-tax cost of each $100 of premium assume premium costs are a fixed proportion of the amount of cover. For example, a 20 per cent increase in the amount of cover will result in a 20 per cent increase in the premium.

TPD case studies

EXAMPLE 9 – 'ANY OCCUPATION' TPD INSURANCE THROUGH SUPER

Peter is 45 years old, has 10 years service in his super fund and a marginal tax rate of 47 per cent. To start with, we're assuming Peter is not subject to Division 293 tax, i.e. his income for the purposes of this tax is within $250,000 (see **Super concessional contributions and the concessional contributions cap** on page 4). His adviser has worked out that he needs $500,000 of 'any occupation' TPD insurance and the premium for this amount of cover is assumed to be $536.

If Peter uses his existing super fund for this insurance under the super options, the pre-tax costs of the options for Peter are as follows:

1. inside super using concessional contributions (CCs) taxed at 15 per cent in the fund (Super CCs @ 15%) – pre-tax cost $579
2. inside super using non-concessional contributions (NCCs) – pre-tax cost $929
3. outside super – pre-tax cost $1,011.

As noted in **Super concessional contributions and the concessional contributions cap** on page 4, if Peter is already using his full CC cap before taking into account the funding of insurance cover but plans to increase his contributions to fund the cover, the relevant comparison is between NCCs and outside super. If Peter is not proposing to increase his super contributions to cover the cost of insurance in super then it is important to bear in mind that insuring inside super will have the effect of eroding concessionally taxed retirement savings.

1. Super CCs

The TPD cover should be grossed up by $39,572 to account for tax on the benefit paid to Peter from the super fund. This is because Peter's 'actual service' period is 10 years and his 'future service' period is 20 years. Assuming his accumulated balance (if any) has no tax free component, approximately two-thirds of Peter's benefit will be tax free with the remaining one-third being taxed at 22 per cent (assuming the benefit is paid before preservation age). So Peter needs $539,572 of TPD cover to gain an after-tax benefit of $500,000. The premium for $539,572 of cover is assumed to be $579.

When funding insurance using CCs, any tax liability on the assessable income of the contributor is offset by a tax deduction on the CCs. The CCs are assessable income in the hands of the fund but that in turn is offset by a tax deduction on the insurance premium. As a result the pre-tax cost will always be equal to the premium of $579.

2. Super NCCs

As with Super CCs, the amount of TPD cover should be $539,572 to cover the tax payable.

When funding insurance using NCCs the contributor's after- tax income is used to make an NCC to super. In Peter's situation, tax of $473 is payable on the gross assessable income leaving $492 which is used to make an NCC. The NCC is not assessable income in the hands of the fund and the fund credits Peter with the value of the deduction it receives for the TPD premium payment. The pre-tax cost is $965, which is calculated as follows:

Income	$929
Less income tax (47%)	($437)
Add benefit of deduction in the super fund	$87
After-tax income/premium	**$579**

3. Outside super

There will be no tax payable on a TPD insurance benefit paid outside super and the amount of cover does not need to be grossed up to account for tax. The premium for $500,000 of cover is assumed to be $536 and the pre-tax cost outside super is $1,011, which is calculated as follows:

Income	$1,011
Less income tax (47%)	($475)
After-tax income/premium	**$536**

What if Peter was subject to Division 293 tax?

If Peter was subject to Division 293 tax, his options for holding TPD insurance still rank in the same order for tax efficiency. However, the pre-tax cost of having insurance inside super using CCs increases from $579 to $743 as a result of the additional tax on contributions. There is no change to the pre-tax cost of having insurance outside super or inside super using NCCs.

In summary, Peter's options are now as follows:

1. inside super using CCs that attract the additional 15 per cent Division 293 tax (Super CCs @ 30%) – pre-tax cost $743
2. inside super using NCCs – pre-tax cost $929
3. outside super – pre-tax cost is $1,011.

Super CCs @ 30%

Again the TPD cover should be grossed up by $39,572 to account for tax on the benefit paid to Peter from the super fund. The grossed up level of TPD cover required is $539,572 and the premium is assumed to be $579.

If Peter was subject to Division 293 tax, any tax liability on Peter's assessable income would continue to be offset by a tax deduction on the CCs. However, Peter will have a personal liability of 15 per cent of the amount of the CC for the Division 293 tax. Assuming Peter pays this tax from non-super sources, the pre-tax cost is $743, calculated as follows:

Income	$743
Less Division 293 tax ($87) and income tax ($77)	($164)
After-tax income/premium	**$536**

EXAMPLE 10 – A SOLUTION TO THE NEED FOR 'OWN OCCUPATION' TPD

Given the nature of Peter's occupation and his education, training and experience, Peter's adviser considers that it would be desirable for him to have the more extensive 'own occupation' cover rather than 'any occupation'. Accordingly, Peter and his adviser have dismissed the prospect of merely having 'any occupation' TPD insurance.

They're aware superannuation regulations prevent 'own occupation' TPD insurance being wholly taken out within super (see **Restrictions on insurance in super** on page 3). However, Peter's adviser knows that some insurers offer split cover arrangements provided via two policies – see **'Own occupation' provided via two policies** on page 27 for further details.

They consider three options for funding the cover:

1. 'own occupation' provided via two policies with the super premium funded with CCs
2. 'own occupation' provided via two policies with the super premium funded with NCCs
3. 'own occupation' outside super.

Under a split cover arrangement, the level of cover should be grossed up to take into account any tax payable should Peter receive a benefit payment from the super fund. Assuming the level of cover should be the same inside and outside of super, the amount of cover will therefore be $539,572 (i.e. the grossed up amount of cover to provide the required net benefit of $500,000).

Peter's adviser calculates the pre-tax cost of using a split cover arrangement with CCs and NCCs and insuring outside of super (assuming that the premium payable for the additional 'own occupation' cover is $289), as follows:

1. split cover 'own occupation' TPD using CCs taxed at 15 per cent in the fund (CCs @ 15%) – pre-tax cost $1,124
2. split cover 'own occupation' TPD using NCCs – pre-tax cost $1,474
3. 'own occupation' outside of superannuation – pre-tax cost $1,519.

Detailed calculations are as follows:

1. Split cover 'own occupation' TPD using CCs @ 15%

If funded from CCs the pre-tax cost is equal to $1,124, of which $579 relates to the policy inside super and $545 relates to the policy outside super.

	Inside super	Outside super
Income	$579	$545
Less income tax (15% in super and 47% outside super)	($87)	($256)
Add benefit of deduction in super fund	$87	$0
After tax income/premium	**$579**	**$289**

2. Split cover 'own occupation' TPD using NCCs

If funded from NCCs the pre-tax cost is equal to $1,474, of which $929 relates to the policy inside super and $545 relates to the policy outside super.

	Inside super	Outside super
Income	$929	$545
Less income tax (47%)	($437)	($256)
Add benefit of deduction in super fund	$87	$0
After tax income/premium	**$579**	**$289**

3. 'Own occupation' fully outside of super

Unlike the split-cover 'own occupation' scenarios, there is no need to gross up the cover to account for tax. The premium for $500,000 of 'own occupation' TPD cover is assumed to be $805 and the pre-tax cost is $1,519, calculated as follows:

Income	$1,519
Less income tax (47%)	($714)
After tax income/premium	**$805**

? Should Peter establish the cover in a separate super fund?

In this situation, Peter would benefit from using a separate super fund for the insurance. This is because the 'actual service' period in the new fund will be shorter which means the tax free component associated with the super benefit will increase, reducing the tax payable. See **Should cover be in a separate fund?** on page 28 for further discussion of these issues.

EXAMPLE 10 – A SOLUTION TO THE NEED FOR 'OWN OCCUPATION' TPD (CONTINUED)

Own occupation' provided via two policies

To ensure compliance with superannuation regulations (see **Restrictions on insurance in super** on page 3) but still benefit from the super tax concessions, clients may wish to consider separating their cover into two distinct parts, as follows:

- a super policy which is basically an 'any occupation' style policy with the additional requirement that the client meets the superannuation law definition of permanent incapacity (that definition being applied as if the insurer was the fund trustee), and
- a non-super policy which covers the remaining part of the 'own occupation' definition of TPD that is not covered under the super policy.

A claim would first be tested under the super policy. The super policy definition is designed to eliminate the issue of the benefit being trapped within the super fund. If the claim meets the TPD definition under the super policy, the full sum insured is paid to the super fund trustee and is subject to superannuation law and the super benefit tax provisions of the tax law.

If the claim meets the TPD definition under the non-super policy, the full sum insured is paid directly to the policy owner of the non-super policy and is not subject to superannuation law or super benefit tax.

There is no overlap in definitions of the cover held under the two policies and a benefit is only ever payable under one of the policies at any point in time.

As tax may apply where a benefit is paid from within super, the level of cover should be grossed up to take into account any tax payable should a benefit payment be made from the super fund.

Where the TPD policy is paid outside of superannuation the client will typically not be taxed on this payment and therefore the net benefit will be greater than if it had been paid under the super policy.

Life insured:	**Client**	
Split cover arrangement for own occupation TPD:	Super component of cover: • meets any occupation, and • meets super law definition of permanent incapacity	Non-super component of cover: • meets own occupation, and • does not meet super policy definition
Policy owner/beneficiary:	**Trustee of Super Fund**	**Client**
	Super premium is fully deductible	**Overcomes the access risk of cover within superannuation (premium is not deductible)**

Should cover be in a separate fund?

Establishing TPD cover in the same fund as accumulating benefits versus a separate fund can impact on the tax efficiency of holding the cover inside super. This is because the tax payable depends on:

- the size of the accumulated benefit (and its tax components) relative to the level of insurance cover, and
- the client's service period.

As explained earlier, there is a conflict between the optimal service period for death benefits (which is only relevant where benefits are to be paid to non-dependent beneficiaries) and the optimal service period for permanent incapacity benefits (see **Non-dependent beneficiaries – should cover be in a separate fund?** on page 15). The best arrangement for a particular client will depend on their circumstances and may change over time.

TPD insurance

While a long service period is beneficial where life insurance is held through super (see **Non-dependent beneficiaries – should cover be in a separate fund?** on page 15), this is not the case for TPD insurance.

In the event a client becomes permanently disabled, benefits payable from superannuation under the permanent incapacity condition of release may include an additional tax free component. As discussed in **Additional tax free component for lump sum disability superannuation benefits** on page 20 the additional tax free component is worked out by calculating the 'future service' component of the benefit. This means that it is beneficial for a client receiving a benefit under the age of 60 to have a short 'actual service' period as that will typically optimise the tax free component. This is illustrated by the following example.

EXAMPLE 11 – TPD COVER THROUGH SUPER – IMPACT OF SERVICE PERIOD

Let's return again to the example of Lisa (see **Example 3 – Life cover through super and payments to non-dependants** on page 13) and assume she also requires a net benefit of $700,000 from her superannuation fund in the event she is permanently incapacitated. As before, Lisa has a service period of 15 years in her existing super fund (Fund A) and $300,000 in accumulated superannuation benefits. In order to achieve a net super benefit of $700,000, she will also need to hold TPD insurance cover inside her fund.

The amount of TPD cover Lisa requires differs depending on whether she applies for her insurance via Fund A or a separate insurance-only super account (Fund B).

Scenario 1 – TPD insurance in Fund A

When insuring through super, the TPD cover should be grossed up to account for tax on the benefit paid from the super fund. If Lisa insures via her existing super account (Fund A) the TPD cover required is $486,517.

If Lisa insures via Fund A then any disability superannuation benefit paid from the fund would be split approximately 50:50 between tax free component and taxable component (element taxed) – see **Additional tax free component for lump sum disability superannuation benefits** on page 20 for further discussion on the calculation of tax components.

The net benefit payable from Fund A is shown in the table below.

Fund A: accumulated benefits and insurance	
Actual service period	15 years
Accumulated benefit	$300,000
TPD insurance	$486,517
Total disability benefit payable	**$786,517**
Components	
Taxable component (element taxed)	$393,258.50
Tax free component	$393,258.50
Tax payable	($86,517)
Net disability benefit	**$700,000**

Scenario 2 – TPD insurance in Fund B

If instead Lisa was to arrange for the TPD cover to be held in a second fund (Fund B), in which she has no accumulated benefit and minimal service period, then the gross TPD cover required reduces to $433,000.

This is because the benefit paid from Fund B, which holds the insurance, is virtually all tax free as there is minimal, or no, past service in the fund. Half of the accumulated benefits paid from Fund A are also tax free. This is shown in the table below.

	Fund A: accumulated benefits	**Fund B: insurance only**
Actual service period	15 years	Virtually nil
Accumulated benefit	$300,000	Nil
TPD insurance	Nil	$433,000
Disability benefit payable	**$300,000**	**$433,000**
Components		
Taxable component (element taxed)	$150,000	Nil
Tax free component	$150,000	$433,000
Tax payable	($33,000)	Nil
Net disability benefit	**$267,000**	**$433,000**
Total		**$700,000**

TRAP

Where TPD insurance is held in a separate fund to accumulating benefits (Fund A), funding insurance premiums via a rollover of accumulated benefits can have the effect of increasing tax on any disability benefits ultimately paid from the fund holding the insurance (Fund B).

Assuming the service period start date in Fund A is earlier than the service period start date of Fund B, any rollover of benefits from Fund A will mean the earlier start date is applied in Fund B. This will increase the 'actual service' period and reduce the additional tax free component of the benefit that would otherwise have applied.

As can be seen above, a key principle for TPD insurance within superannuation is to have as little 'actual service' applying to a benefit as possible. This will typically optimise the tax free component of any disability benefits paid from the fund. For clients with a lengthy period of 'actual service', consideration could be given to establishing TPD cover in a separate superannuation fund. However, a shorter service period has a negative impact on the tax efficiency outcomes for life insurance – see Non-dependent beneficiaries – should cover be in a separate fund? on page 15 for further details.

TPD insurance – general principles

Based on the stated assumptions (see Assumptions used in this guide on page 6 and Key additional assumptions on page 21) and analysis, we have distilled the following general principles for establishing TPD insurance.

- **Funding cover in super is tax efficient for cover aligned with the superannuation law release conditions (typically 'any occupation' TPD).** This is particularly the case where premiums are funded with concessional contributions (CCs), but also generally applies for non- concessional contributions (NCCs). See Tax efficiency comparison on page 21.
- **However, funding cover outside super may be more tax efficient than super NCCs for clients age 50 or more but less than preservation age whose fund service period started before age 31.** For such clients, the effective rate of benefits tax on super benefits can be higher than the value of the deduction claimed in the fund for the premium. See Key additional assumptions on page 21.
- **Subject to life insurance considerations if death benefits are paid to tax non-dependants, clients with lengthy service periods may benefit from structuring TPD in a separate super fund from accumulating benefits.** See Should cover be in a separate fund? on page 28.
- **Split cover arrangements may suit clients who require insurance not aligned with superannuation law release conditions (typically 'own occupation' TPD).** See Example 10 – A solution to the need for 'own occupation' TPD on page 27.

> "...a key principle for TPD insurance within superannuation is to have as little 'actual service' applying to a benefit as possible, because this will typically optimise the tax free component of any disability benefits paid from the fund."

Disability income insurance

What is disability income insurance?

Disability income insurance (DII) provides a monthly benefit that replaces income if the insured person becomes disabled due to illness or injury.

The disability definition for insurance purposes will depend on the policy terms offered by the insurance provider.

How are insurance benefits accessed?

Non-super benefits

Benefits payable under a DII policy held outside super will generally be paid to the policy owner.

Super benefits

Benefits payable under a DII policy held inside superannuation will generally be paid to the trustee of the superannuation fund owning the policy. The insurance proceeds will then be paid to the insured client, providing a superannuation law condition of release has been met.

New DII cover taken out within superannuation from 1 July 2014 will typically be aligned with the superannuation law definition of temporary incapacity (see **Restrictions on insurance in super** on page 3). This ensures that where a client meets this condition of release benefits payable to a super fund trustee under a DII policy will typically be able to be paid immediately to the client. However, the temporary incapacity payment rules mean that the range of benefits offered under a DII policy held within super may be limited when compared with a non-super policy. The payment of benefits may also be restricted in certain circumstances.

Below are some examples of scenarios in which DII benefits may be limited if cover is held within superannuation.

Scenario 1 – unemployed at time of disability: Andrew's line of work means that from time to time he moves from one contract of service to another. The super law definition of temporary incapacity refers to ill-health that caused the member to cease to be gainfully employed. If Andrew became temporarily ill just after he had finished one contract and before he could commence another, he may not meet the super law definition of temporary incapacity, as his employment ceased because his contract ended, not because of his ill-health. DII policies taken out within superannuation from 1 July 2014 typically include a requirement that the insured person was employed at the time of disability. If they are unemployed, no benefit would be payable.

Scenario 2 – continuity of employment: The super law definition of temporary incapacity requires either cessation of gainful employment or at least temporary cessation of gain or reward from employment. If, due to an injury, Abbie was to spend some time on paid sick leave then return to work in a reduced capacity, she may not meet the temporary incapacity condition of release given her employment or wages did not cease at any stage.

Scenario 3 – additional benefits: Audrey perceives that some of the additional benefits offered under a typical DII policy are particularly worthwhile, such as benefits to address bed confinement, home care, rehabilitation expenses and family accommodation needs. However, depending on the circumstances in which such benefits become payable, they may be inconsistent with the temporary incapacity condition of release and payment rules.

Also, temporary incapacity benefits can only be paid in the form of a non-commutable income stream. Payments must be made monthly and variations, such as indexation are limited to CPI or 5 per cent per annum. Additional benefits cannot be paid as a lump sum.

TEMPORARY INCAPACITY TRAP

The temporary incapacity condition of release requires a member to have ceased gainful employment because of ill-health, including where the member has ceased temporarily to receive gain or reward under a continuing gainful employment arrangement.

In addition, temporary incapacity benefits can only be paid in the form of a non-commutable income stream, subject to indexation constraints.

These rules can be restrictive compared to DII products.

Super fund trustees are not able to take out DII cover which does not align with certain conditions of release (see **Restrictions on insurance in super** on page 3). However, this restriction generally does not apply for DII cover that was in place prior to 1 July 2014, although there is a risk of benefits being trapped in superannuation.

One option to deal with these issues is to arrange the cover outside superannuation (which is typically **tax efficient – see Tax efficiency comparison** on page 32). However, some clients may wish to structure their DII cover through superannuation, for example, for cash flow reasons or to provide scope to commute benefits to a lump sum and receive superannuation benefit concessions in the event of permanent incapacity. For such clients, consideration could be given to split cover arrangements which involve some cover being held inside super (which aligns with the super law) and the remainder being held outside super (which provides benefits beyond the super law constraints). See **Example 13 – Split cover DII** on page 33.

Permanent incapacity – lump sums and normal super income streams can be accessed

By contrast, if a client meets the definition of permanent incapacity, then there may be scope for the super fund trustee to pay benefits in the form of a lump sum or a normal super income stream without constraint on the size of the payments.

This opens up more planning opportunities if the income protection benefits are able to be commuted to a lump sum. The super fund can then pay the benefit to the client as a lump sum (taxed at a maximum of 22 per cent) or an income stream benefit (that meets the superannuation law pension standards) on the basis that the client has become permanently incapacitated. A 15 per cent tax offset will be available on any taxable component of the income stream up until the age of 60, and from age 60 the income stream will be tax free.

Tax treatment of premiums and proceeds

Non-super

Where the disability income policy is owned by a client to protect against loss of their own income the premiums are generally tax deductible to the client.

Disability income benefits will typically be fully assessable at a client's marginal tax rate.

Within super

Premiums

In Tax Determination TD 2007/3 (now withdrawn), the ATO effectively recognised that DII premiums paid by a super fund trustee are deductible to the extent that they are to enable the trustee to pay temporary incapacity benefits in accordance with the superannuation law payment standards. This means that premiums may be deductible for policies providing basic income protection benefits until age 65 or even later provided the benefit payment period does not exceed the period of incapacity.

DII DEDUCTIBILITY TRAP

The ATO has noted that certain policy features of typical DII policies which do not meet the super law payment rules, such as when benefits are provided for someone who continues to work part-time or where the value of the cover exceeds the person's remuneration at the time they became ill. The implication is that, where this cover is held inside superannuation, the premium may not be fully deductible.

However, from 1 July 2014 super fund trustees are not able to take out DII cover which provides these features (see Restrictions on insurance in super on page 3) and benefits provided under the policy should be aligned with the super payment rules.

For clients who wish to have comprehensive DII cover, advisers should consider either structuring the cover outside superannuation or arrangements under which the deductible part of the cover (the part that is aligned with the super law payment rules) is held inside super and the remainder is held outside super (see Example 13 – Split cover DII on page 33).

Proceeds

ATO practice is to treat proceeds as not assessable in the hands of the super fund trustee.

Benefits paid from super fund

Disability income benefits paid from superannuation will typically be fully assessable at a client's marginal tax rate. However, more favourable treatment may be available for super income streams paid in the event of permanent incapacity (see **Tax treatment of premiums and proceeds** on pages 20 to 23).

Tax efficiency comparison

Tax comparison

This analysis considers three options for funding DII cover:

- **outside super –** paying for the insurance premiums with after- tax income and holding the policy in the client's own name
- **super CCs –** arranging for concessional contributions (CCs) to be made to a super fund and for the fund trustee to pay the premium and hold the DII policy in its name with the client has the insured member
- **super NCCs –** making non-concessional contributions (NCCs) to a super fund and for the fund trustee to pay the premium and hold the DII policy in its name with the client as the insured member.

As with the other types of insurance, the starting point for this analysis is to consider the pre-tax cost of disability income insurance for each $100 of premium.

The pre-tax cost is the amount of a client's gross remuneration package that would be needed to pay the premium. The table shows this pre-tax cost (rounded to the nearest dollar) for each $100 of premium. The effects of tax payable by clients on the benefits are ignored because benefits are assumed to be fully assessable in all cases. See **Calculating the pre-tax cost** below for the relevant formulae.

<table>
<tr><th colspan="5">Pre-tax cost for each $100 of premium</th></tr>
<tr><th>Client's marginal tax rate</th><th>Non-Super</th><th>Super CCs @ 15%</th><th>Super CCs @ 30%</th><th>Super NCCs</th></tr>
<tr><td>34.5%</td><td>$100</td><td rowspan="3">$100</td><td rowspan="2">N/A</td><td>$130</td></tr>
<tr><td>39%</td><td>$100</td><td>$139</td></tr>
<tr><td>47%</td><td>$100</td><td>$128</td><td>$160</td></tr>
</table>

Key additional assumptions

The following assumptions are made in addition to those set out in the Assumptions used in this guide on page 6.

- **Premium deductibility**
  Premiums in all cases are fully tax deductible to the payer. The cover is assumed to be aligned with the temporary incapacity condition of release and payment rules.
- **Benefits fully assessable**
  The analysis ignores tax payable on benefits received because disability income benefits will typically be fully assessable at a client's marginal tax rate under all options. However, note that more favourable treatment may be available for super income streams paid in the event of permanent incapacity.

TRAP

DII funded with NCCs is typically not tax efficient.

The tax efficiency reduces where the insurance is held in insurance-only super arrangements and premiums are funded by contributions that are not taxable (for example NCCs). This is because the tax effect of a deduction available to the fund trustee in relation to policy premiums is typically not credited to members' accounts.

In this situation, the pre-tax cost for each $100 of premium effectively increases where the premium is funded by Super NCCs.

Calculating the pre-tax cost

The table on the right shows the TPD benefit formula used to calculate the pre-tax cost of each $100 of premium for TPD insurance.

Where:

- "MTR" refers to the client's marginal tax rate
- "SF tax" refers to the super fund tax rate of 15 per cent
- "Div 293 tax" refers to the additional 15 per cent Division 293 tax (assumed to be paid from non-super sources).

Funding option	Pre-tax cost
Non-super	$\frac{\$100 \times (1\text{-MTR})}{(1\text{-MTR})}$
Super CCs @ 15%	$\frac{\$100 \times (1\text{-SF tax})}{(1\text{-SF tax})}$
Super CCs @ 30%	$\frac{\$100 \times (1\text{-SF tax})}{(1\text{-SF tax})} + \frac{\$100 \times \text{Div 293 tax}}{(1\text{-MTR})}$
Super NCCs	$\frac{\$100 \times (1\text{-SF tax})}{(1\text{-MTR})}$

Disability Income Insurance case studies

EXAMPLE 12 – DISABILITY INCOME BENEFITS IN SUPER

Evan is 40 years old and has a marginal tax rate of 47 per cent. His adviser has worked out he needs basic DII cover with a monthly insured amount of $15,000. The annual premium for this amount of cover is assumed to be $1,557.

To start with, we will assume Evan is not subject to Division 293 tax, i.e. his income for the purposes of this tax is less than $250,000 (see **Super concessional contributions and the concessional contributions cap** on page 4).

Any monthly benefit payable under the policy will be assessable income for Evan regardless of whether the cover is owned inside or outside super.

? Evan hold his DI insurance inside or outside super?

1. outside super – pre-tax cost $1,557
2. inside super using concessional contributions (CCs) taxed at 15 per cent in the fund (Super CCs @ 15%) – pre-tax cost $1,557
3. inside super using non-concessional contributions (NCCs) – pre-tax cost $2,497.

As noted in **Super concessional contributions and the concessional contributions cap** on page 4, if Evan is already using his full CC cap before taking into account the funding of insurance cover but plans to increase his contributions to fund the cover, the relevant comparison is between NCCs and outside super. In any case, if Evan is not proposing to increase his super contributions to cover the cost of insurance in super then it is important to bear in mind that insuring inside super will have the effect of eroding concessionally taxed retirement savings.

1. Outside super

Premiums for DII are fully tax deductible outside super and any tax liability on the assessable income is offset by the tax deduction on the insurance premium. As a result the pre-tax cost is equal to the premium of $1,557.

2. Super CCs @ 15%

When funding insurance within super using CCs, any tax liability on the assessable income of the contributor is offset by a tax deduction on the CCs. The CCs are assessable income in the hands of the fund but that in turn is offset by a tax deduction on the insurance premium. As a result the pre- tax cost is equal to the premium of $1,557.

3. Super NCCs

When funding insurance within super using NCCs the contributor's after-tax income is used to make an NCC to super. In Evan's situation, tax of $1,174 is payable on the gross assessable income leaving $1,323 which is used to make an NCC. The NCC is not assessable income in the hands of the fund and the fund credits Evan with the value of the deduction it receives for the DII premium payment. The pre-tax cost is $2,497, which is calculated as follows:

Income	$2,497
Less income tax (47%)	($1,174)
Add benefit of deduction in the super fund	$234
After-tax income/premium	**$1,557**

? What if Evan was subject to Division 293 tax?

If Evan was subject to Division 293 tax, the pre-tax cost of funding insurance inside super using CCs increases from $1,557 to $1,998 as a result of the additional tax on contributions. There is no change to the pre-tax cost of having insurance outside super or inside super using NCCs.

In summary, Evan's options are now as follows:

- outside super – pre-tax cost $1,557
- inside super using CCs that attract the additional 15 per cent Division 293 tax (Super CCs @ 30%) – pre-tax cost $1,998
- inside super using NCCs – pre-tax cost $2,497

Super CCs @ 30%

If Evan was subject to Division 293 tax, any tax liability on Evan's assessable income would continue to be offset by a tax deduction on the CCs. However, Evan will have a personal liability of 15 per cent of the amount of the CC for Division 293 tax. Assuming Evan pays this tax from non-super sources, the pre-tax cost is $1,998, calculated as follows:

Income	$1,998
Less Division 293 tax ($234) and income tax ($207)	($441)
After-tax income/premium	**$1,557**

EXAMPLE 13 –SPLIT COVER DII

Helen is looking to take out DII cover through her super fund. However, she is concerned to ensure she has comprehensive cover. For example, she wants to ensure that she is covered if she becomes unemployed before suffering an illness or injury. She also sees the appeal in having access to benefits such as those to address bed confinement, home care, rehabilitation expenses and family accommodation needs.

? What are her options?

Some insurers offer parts of DII cover that do not align with super law under a separate policy that sits outside of superannuation. This will allow Helen to take part of her DII inside super and have remainder of the cover held outside super.

EXAMPLE 14 – DII BENEFITS IN SUPER AND TPD COMMUTATION OPTION

Maria, aged 40, has been unable to work for 30 days due to ill health and is looking at making a claim for a disability income benefit via her DII policy. Maria's monthly benefit is $10,000 and her policy also includes an option to commute the income stream to a lump sum in the event of her total and permanent disablement.

If Maria satisfies the policy's total disability definition, will she be able to access the benefits?

The definition of total disability under Maria's policy is closely aligned with the superannuation law definition of temporary incapacity. The super fund trustee is satisfied that Maria has met that condition of release so she will be able to access DII benefits from the fund. Maria has no other income and would like to know what after-tax benefit she will receive.

The monthly benefit is assessable income for Maria.

Ignoring any other income, deductions or offsets that Maria may be entitled to, her after-tax benefit is calculated as follows:

Annual DII income	$120,000
Less tax on taxable income	($29,467)
Less Medicare levy	($2,400)
Annual after tax income	**$88,133**
Monthly after tax benefit	**$7,344**

Commutation on TPD

Assume that Maria has been unable to work for over

12 months and is unlikely to be able to work in future. She is considering converting her DII benefits to a lump sum using the TPD Commutation option offered by her insurer. What issues should she consider?

By taking the TPD commutation option Maria's super account will receive a lump sum of $1.56 million calculated based on an assumed commutation multiple of 156 (i.e. $10,000 x 156 = $1,560,000). Note that the multiple applicable will depend on the particular insurer's product terms and conditions and may be determined by the age of the insured at the time the benefit is paid.

Once Maria's super account is credited with the lump sum, she has a number of options including the following.

1. Cashing all or part of the benefit from the fund

The super benefit may be subject to tax but the benefit should include a tax free component (see **Tax treatment of premiums and proceeds** on pages 20 to 23).

2. Commencing a super income stream

The taxable component of the super income stream will receive a 15 per cent tax offset on the basis that it is considered a 'disability superannuation benefit' (see **Tax treatment of premiums and proceeds** on pages 20 to 23).

As a result of the 15 per cent tax offset and reduced level of tax, Maria only needs to take a monthly income stream of $8,137 from her super account in order to achieve the same after-tax monthly income of $7,344 had she continued with the DII policy. This is calculated as follows:

Annual super income stream	$97,640
Less tax on taxable income	($22,200)
Less Medicare levy	($1,953)
Add 15% tax offset	$14,646
Annual after tax income	**$88,133**
Monthly after tax benefit	**$7,344**

In the example we have assumed that the income stream is fully taxable and that Maria will receive a 15 per cent tax offset on this income.

If Maria's super account included a tax free component, a portion of the income stream would be tax free. For instance, if 30 per cent of Maria's account was tax free component, then 30 per cent of the income stream would also be tax free.

Note that the ATO takes the view that an increase in the tax free component that applies in respect of lump sums that qualify as 'disability superannuation benefits' does not arise where benefits are transferred within the same fund to commence an income stream. However, it does potentially apply in respect of a lump sum that is rolled over to another superannuation fund.

The transfer balance cap applicable from limits the superannuation benefits, including amounts payable under the TPD commutation option, Maria can use to commence a super income stream.

3. A combination of 1 and 2

When assessing the appeal of the TPD commutation option, Maria should consider the possibility of there being a capital value at age 65. Age 65 is the time at which many DII policies cease paying a benefit. By including the TPD commutation option in her policy, if Maria makes a claim on the policy before age 65, then depending on the investment performance of the fund and the extent of her benefit drawdowns, Maria may have a lump sum remaining at age 65 to assist with meeting her living expenses.

Choosing the commutation may also prove to be advantageous in the situation where Maria ultimately passes away after the commutation but prior to age 65. This is because in the absence of commutation the DII policy will stop paying a regular benefit on Maria's death whereas under the TPD commutation option there may still be a lump sum remaining that will pass to Maria's beneficiaries.

Maria should also take into consideration the fact that the commutation option shifts the investment risk from the insurer to Maria – she may need to manage the risk with the help of her adviser.

Disability income insurance – general principles

Based on the stated assumptions (see **Assumptions used in this guide** on page 6 and **Key additional assumptions** on page 32) and analysis, we have distilled the following general principles for establishing disability income insurance.

- **Funding cover in super with concessional contributions (CCs) taxed at 15 per cent is tax efficient for basic cover. However cover in super may not be comprehensive due to limitations in super law.** See Tax efficiency comparison on page 32 and How are insurance benefits accessed? on page 30.
- **A TPD commutation option may provide appeal.** See How are insurance benefits accessed? on page 30 and Example 14 – DII benefits in super and TPD commutation option on page 34.
- **Funding cover outside super is tax efficient and may be preferable for cover that does not align with super law.** See How are insurance benefits accessed? on page 30.
- **Funding cover in super with CCs subject to Division 293 tax and non-concessional contributions (NCCs) is not tax efficient.** See Tax efficiency comparison on page 32 and Example 12 – Disability income benefits in super on page 33.
- **Split cover arrangements may suit clients who require insurance not aligned with superannuation law release conditions but have cash flow constraints.** See Example 13 – Split cover DII on page 33.

Trauma insurance

What is trauma insurance?

Trauma insurance provides a lump sum benefit if the insured person suffers a medical condition or other trauma events in accordance with the trauma policy terms.

The medical conditions and trauma events covered will depend on the policy terms offered by the insurance provider.

How are insurance benefits accessed?

Non-super benefits

Benefits payable under a trauma policy held outside super will generally be paid to the policy owner.

Super benefits

Scope for super fund trustees to hold trauma insurance?

Superannuation regulations prevent super fund trustees from taking out trauma insurance. Trauma insurance cover held for existing members that was in place prior to 1 July 2014 is not subject to these regulations.

For superannuation fund trustees that hold trauma insurance cover for members put in place prior to 1 July 2014, it is important to bear in mind that current superannuation law (in particular, the 'sole purpose test' and the 'payment standards') requires super funds to be maintained to provide benefits when particular conditions are met. It does not provide for payment of super benefits from funds in the event of a member acquiring a medical condition which qualifies them for a typical trauma insurance benefit.

Trustees of funds should seek their own legal advice as to whether the arrangements comply with superannuation law in particular circumstances.

Where trauma insurance is held inside super, benefits payable under the policy will be paid to the trustee of the superannuation fund owning the policy. The proceeds will then typically form part of the member's benefit within the fund.

In order to pay any superannuation benefits from the fund, the trustee must be satisfied the member has met a superannuation law condition of release, such as permanent incapacity.

Given that trauma is not a recognised condition of release for super benefits, if trauma insurance proceeds are received by a super fund trustee, the trustee will not be able to pay them unless a condition of release is satisfied such as permanent incapacity, commencing a TTR pension from preservation age, retirement or attaining age 65. Clients will need to assess whether or not this constraint on access to super benefits is problematic given their circumstances.

"The medical conditions and trauma events covered will depend on the policy terms offered by the insurance provider."

Tax treatment of premiums and proceeds

Non-super

Where the trauma policy is owned by the insured person, premiums are not tax deductible and any capital gain made on the payment of a trauma benefit is disregarded where the benefit is paid to the insured person or their relatives.

Within super

The following information is only applicable for superannuation fund trustees that held trauma insurance cover for members prior to 1 July 2014. New trauma cover cannot be established inside superannuation from this date.

Trauma insurance proceeds are generally added to the taxable component of a client's superannuation account.

- **Premiums** – Where the trauma policy is held within superannuation, premiums are not tax deductible to the fund trustee.
- **Proceeds** – Any capital gain made on the payment of a trauma insurance benefit to the super fund trustee is generally disregarded. However, any benefit subsequently paid from the superannuation fund may be taxable.
- **Superannuation benefits** – Where a client has met a condition of release and is eligible to access their superannuation benefits, lump sum payments will be taxed as follows in 2023/24:

Taxpayer's age	Tax free component	Taxable component	
		Element taxed	Element untaxed
Under preservation age	Non-assessable non-exempt income	20%	30%* up to $1,705,000[10] 45%* above $1,705,000[10]
Preservation age to 59		0% up to $235,000[11] 15%* above $235,000[11]	15%* up to $235,000[11] 30%* from $235,000[11] – $1,705,000[10] 45%* above $1,705,000[10]
60 and over	Non-assessable non-exempt income		15%* up to $1,705,000[10] 45%* above $1,705,000[10]

* Plus Medicare levy.

Tax efficiency comparison

Tax comparison

This analysis considers three options for funding insurance cover:

- **outside super** – paying for the insurance premiums with after-tax income and holding the policy in the client's own name
- **super CCs** – arranging for concessional contributions (CCs) to be made to a super fund and for the fund trustee to pay the premium and hold the trauma policy in its name with the client has the insured member
- **super NCCs** – making non-concessional contributions (NCCs) to a super fund and for the fund trustee to pay the premium and hold the policy in its name with the client as the insured member.

As with the other types of insurance, the starting point for this analysis is to consider the pre-tax cost of disability income insurance for each $100 of premium.

The pre-tax cost is the amount of a client's gross remuneration package that would be needed to pay the premium. The table shows this pre-tax cost (rounded to the nearest dollar) for each $100 of premium. The premiums in super are grossed up for the 17 per cent tax that may be payable by a member aged from preservation age to 59. See **Calculating the pre-tax cost** on page 38 for relevant formulae.

Pre-tax cost for each $100 of premium with benefits tax (17%)

Client's marginal tax rate	Non-Super	Super CCs @ 15%	Super CCs @ 30%	Super NCCs
34.5%	$153		N/A	$184
39%	$64	$142		$198
47%	$189		$170	$227

10 Untaxed plan cap in 2023/24. This is a lifetime cap, per plan, indexed annually with Average Weekly Ordinary Time Earnings (AWOTE) rounded down to the nearest $5,000.
11 Low rate cap in 2023/34. This is a lifetime cap, indexed annually with AWOTE, rounded down to the nearest $5,000 and reduced by previous taxable lump sum member benefits received between preservation age and age 60.

Key additional assumptions

The following assumptions are made in addition to those set out in the **Assumptions used in this guide** on page 6.

- **Premium deductibility**
  Premiums in all cases are non-deductible to the payer.
- **Super benefits taxed**
  The super benefits are subject to tax of 17 per cent, that is, they are paid to the client from preservation age to 59 inclusive from a taxed superannuation fund and the low rate cap is not available. It is assumed that the benefits are not payable before preservation age (see **How are insurance benefits accessed?** on page 36).

Calculating the pre-tax cost

The table on the right shows the trauma benefit formula used to calculate the pre-tax cost of each $100 of premium for trauma insurance.

Where:

- MTR" refers to the client's marginal tax rate
- "SF tax" refers to the super fund tax rate of 15 per cent
- "BF tax" is the effective benefits tax that is payable on superannuation lump sums
- "Div 293 tax" refers to the additional 15 per cent Division 293 tax (assumed to be paid from non-super sources).

Funding option	Pre-tax cost
Non-super	$\frac{\$100}{(1\text{-MTR})}$
Super CCs @ 15%	$\frac{\$100}{(1\text{-SF tax}) \times (1\text{-BF tax})}$
Super CCs @ 30%	$\frac{\$100}{(1\text{-SF tax}) \times (1\text{-BF tax})} + \frac{\$100 \times \text{Div 293 tax}}{(1\text{-MTR})}$
Super NCCs	$\frac{\$100}{(1\text{-MTR}) \times (1\text{-BF tax})}$

Note – calculations for the pre-tax cost of each $100 of premium assume premium costs are a fixed proportion of the amount of cover. For example, a 20 per cent increase in the amount of cover will result in a 20 per cent increase in the premium.

Trauma case study

EXAMPLE 15 – ACCESSING TRAUMA BENEFITS

Albert (aged 50) holds trauma insurance of $150,000 outside of super to assist in meeting his medical and living expenses (including mortgage repayments) in case of a trauma event.

Albert recently suffered a stroke requiring him to take two months off work without pay. Albert was fortunate and has been able to resume his previous role and is almost back to full health.

Albert was paid his trauma benefit of $150,000 which was essential to fund his medical and living expenses during his time off work. Without this cover Albert would have some significant cash flow issues.

Had this insurance been held inside super the trauma benefit would be paid to his super account. As Albert is unable to satisfy the permanent incapacity condition of release (or any other condition of release) his trauma benefit would remain in his super account and be inaccessible.

Trauma insurance – general principles

Based on the stated assumptions (see **Assumptions used in this guide** on page 6 and **Key additional assumptions** on page 38) and analysis, we have distilled the following general principles for establishing trauma insurance.

- **Funding cover in super with concessional contributions (CCs) is tax efficient but need to consider the superannuation law and benefit access issues.** Trauma is not permitted to be taken out in super from 1 July 2014. See **How are insurance benefits accessed?** on page 36 and Tax efficiency comparison on page 37.
- **Non-super arrangements solve access and other superannuation law constraints.** See **How are insurance benefits accessed?** on page 36 and **Example 15 – Accessing trauma benefits** on the left.
- **Funding cover outside super is more tax efficient than super non-concessional contributions (NCCs) and there will be the need to consider the superannuation law and benefit access issues.** See **Tax efficiency comparison** on page 37.

Additional considerations for SMSFs

Benefit deductions instead of premium deductions

When comparing insuring inside and outside superannuation, the focus is typically on situations where premiums payable for cover inside super are claimed as a tax deduction. However, tax law allows fund trustees the choice not to claim the premiums and instead to claim a deduction at the point a benefit is paid from the fund based on the 'future service' portion of the benefit (including both insurance and any accumulated balance).

In practice, this concession is typically only available to self managed superannuation funds (SMSFs). This is because it is not possible for a fund to claim premium deductions for some members and benefit deductions for others in the same income year and, once a fund has made this election, it generally applies to all future income years. If a large fund was to make such an election in relation to one member's benefits, other members of the fund are likely to be disadvantaged as the fund would no longer be able to claim premiums for that member as a deduction.

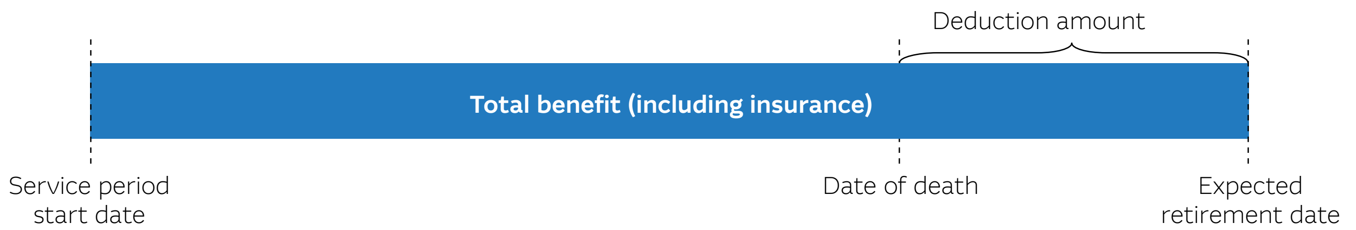
This alternative can be illustrated by way of an example. The following example is based on a death benefit but a deduction for the 'future service' portion of a benefit is also available in relation to benefits paid on terminal illness grounds, disability superannuation benefits and temporary incapacity benefits. (In the latter case the deduction is calculated based on the total of the benefits paid in an income year.)

EXAMPLE 16 – 'FUTURE SERVICE' DEDUCTION CLAIMED BY SMSF

George, aged 35, has a balance of $200,000 and has just established life and TPD cover of $1 million each in his SMSF. George works as an employee and has a current service period of 10 years.

Assume George continues to work as an employee until he dies at age 55 in 20 years time. At this time his accumulated balance has increased to $500,000 so the death benefit payable from the fund is $1.5 million.

If the SMSF trustee elects, either in the year the death benefit is paid or an earlier income year, not to claim a deduction for the premiums, the fund can claim a deduction for the 'future service' portion of the death benefit. This is shown in the diagram below:



The amount of the deduction is approximately $375,000 i.e. approximately 25 per cent of the total benefit. This amount can be claimed whether the benefit is paid as a lump sum death benefit or used to commence a death benefit pension.

By making use of this alternative concession, George's SMSF can potentially benefit from a larger tax deduction than would otherwise be available.

Important considerations

It is important to note the following considerations:

- for a benefit paid in respect of a member aged 65 or more, there will typically be no 'future service' portion and hence no deduction available in respect of the benefit
- the 'future service' deduction requires that the benefit is paid in consequence of the termination of a member's employment. The deduction cannot be claimed by a fund if the payment is made in respect of a self-employed member or a member who was not employed
- the election not to claim premiums as a tax deduction applies to all future income years as well. Therefore consideration should be given to the impact an election may have on the tax efficiency of other members' insurance arrangements in future
- if the fund does not have sufficient assessable income in the year the 'future service' deduction is claimed, it will have a carry forward loss and consideration should be given as to whether the fund will be able to use this loss in future
- the ATO has expressed a view that, in order to claim the 'future service' deduction, the fund must have an insurance policy[12] and must have paid premiums on that policy in the income year of benefit payment.[13] A fund that is only paying out a member's accumulated benefits cannot claim the 'future service' deduction.

Note that the same benefits tax treatment applies regardless of whether the fund has claimed the premiums as a tax deduction or claimed the 'future service' portion of the benefit. That is, the benefit will be tax free if paid to a tax dependant and the taxable component will be subject to tax if paid to a tax non-dependant. If paid to a tax non- dependant, an 'element untaxed' is included in the benefit which is taxed at a higher rate (see **Tax treatment of premiums and proceeds** on page 7).

12 See, for example, Edited Private Advice, Authorisation Number: 1012057834929 and Authorisation Number: 1011490692642.
13 See, for example, Edited Private Advice, Authorisation Number: 1012695230090 and Authorisation Number: 1012624952872.

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